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# **2006 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE**



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**United States Trade Representative**



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ON CHINA'S WTO COMPLIANCE**

**December 11, 2006**

**United States Trade Representative**



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**APPENDIX 1** (List of Written Submissions)

**APPENDIX 2** (List of Witnesses)

## **FOREWORD**

This is the fifth report prepared pursuant to section 421 of the U.S.-China Relations Act of 2000 (P.L. 106-286), 22 U.S.C. § 6951 (the Act), which requires the United States Trade Representative (USTR) to report annually to Congress on compliance by the People's Republic of China (China) with commitments made in connection with its accession to the World Trade Organization (WTO), including both multilateral commitments and any bilateral commitments made to the United States. The report also incorporates the findings of the Overseas Compliance Program, as required by section 413(b)(2) of the Act, 22 U.S.C. § 6943(b)(2).

Like the prior reports, this report is structured as an examination of the nine broad categories of WTO commitments undertaken by China. Throughout the report, USTR has attempted to provide as complete a picture of China's WTO compliance as possible, subject to the inherent constraints presented by the sheer volume and complexity of the required changes to China's trade regime and transparency obstacles. The report identifies areas where progress has been achieved and underscores shortcomings, as appropriate, with regard to the commitments that became effective upon China's accession to the WTO as well as those commitments scheduled to be phased in over time.

The focus of the report's analysis continues to be on trade concerns raised by U.S. stakeholders that, in the view of the U.S. Government, merit attention within the WTO context. The report does not provide an exhaustive analysis of the many areas in which China's WTO compliance efforts have or have not, in the view of the U.S. Government, satisfied particular commitments made in China's WTO accession agreement.

In preparing this report, USTR drew on its experience in overseeing the U.S. Government's monitoring of China's WTO compliance efforts. USTR chairs the Trade Policy Staff Committee (TPSC) Subcommittee on China WTO Compliance, an inter-agency body whose mandate is devoted to China and the extent to which it is complying with its WTO commitments. This TPSC subcommittee is composed of experts from USTR, the Departments of Commerce, State, Agriculture and Treasury, and the U.S. Patent and Trademark Office, among other agencies. It works closely with State Department economic officers, Foreign Commercial Service officers and Market Access and Compliance officers from the Commerce Department, Foreign Agricultural Service officers and Customs attaches at the U.S. Embassy and Consulates General in China, who are active in gathering and analyzing information, maintaining regular contacts with U.S. industries operating in China and maintaining a regular dialogue with Chinese government officials at key ministries and agencies. The subcommittee meets in order to evaluate, coordinate and prioritize the monitoring activities being undertaken and to review the steps that China has taken to implement its commitments.

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To aid in its preparation of this report, USTR also published a notice in the Federal Register on July 28, 2006, asking for written comments and testimony from the public and scheduling a public hearing before the TPSC, which took place on September 28, 2006. A list of the written submissions received from interested parties is set forth in Appendix 1, and the persons who testified before the TPSC are identified in Appendix 2.



## EXECUTIVE SUMMARY

When China acceded to the World Trade Organization on December 11, 2001, it committed to implement over time a set of sweeping reforms that required it to lower trade barriers in virtually every sector of the economy, provide national treatment and improved market access to goods and services imported from the United States and other WTO members, and protect intellectual property rights. Five years later, the deadlines for almost all of China's commitments have passed, and China's transition period as a new WTO Member is now essentially over. This report provides an assessment of China's performance in meeting its WTO obligations during this transition period, with a particular emphasis on developments during the past year.

China has taken significant and often impressive steps to reform its economy since acceding to the WTO. During this period, China has repealed, revised or enacted more than one thousand laws, regulations and other measures in an effort to bring its trading system into basic compliance with WTO standards. China has also taken steps to implement numerous specific commitments pursuant to schedules set forth in its WTO accession agreement. Each year, China has made annual reductions in its tariff rates, eliminated non-tariff barriers, expanded market access for foreign services providers and improved transparency. All of these steps were designed to deepen China's integration into the international trading system, as well as to facilitate and strengthen economic reforms that China had begun 20 years earlier. The United States – including U.S. workers, businesses, farmers, service providers and consumers – has benefitted significantly from these steps and continues to do so as U.S.-China trade grows.

Nevertheless, despite significant progress in many areas, China's record in implementing WTO commitments is decidedly mixed. China continues to pursue problematic industrial policies that rely on trade-distorting measures such as local content requirements, import and export restrictions, discriminatory regulations and prohibited subsidies, all of which raise serious WTO concerns. China's shortcomings in enforcing laws in areas where detailed WTO disciplines apply, such as intellectual property rights (IPR), have also created serious problems for the United States and its other trading partners.

U.S. industry traces many of the United States' most difficult trade issues with China to excessive Chinese government intervention in the market through policy directives and the actions of individual officials. This government intervention, evident in many areas of China's economy, is a reflection of China's historic yet unfinished transition from a centrally planned economy to a free-market economy governed by rule of law. To some extent, these difficulties were anticipated. During the fifteen years of negotiations leading up to China's WTO accession, the United States and other WTO members were aware of the state's large role in China's economy and carefully negotiated conditions for China's WTO accession that would, when implemented, lead to significantly reduced levels of government intervention in the market and distortions in trade flows attributable to it.

Noteworthy progress was made as a result of economic reforms adopted by China before and in the first few years after its accession to the WTO. But, there are indications that progress toward further market liberalization slowed in 2006, as several U.S. trade associations highlighted in their written comments and testimony this Fall before USTR and the other agencies that comprise the Trade Policy Staff Committee.

One trade association official explained:

Recent public policy debates in China have indicated a dampening of enthusiasm in some quarters for foreign participation in the economy. Some in China also appear to want to expand the government's role in directing the economy and in developing internationally competitive Chinese enterprises, while also restricting the role of international companies in certain sectors.

Another trade association official cautioned:

Over the past 12 months we have seen an upsurge in industrial planning measures as tools of economic development by central government authorities. China's leaders currently face a choice: either to narrowly interpret WTO commitments and maximize the use of government intervention to protect and nurture Chinese industries, or to apply the letter and spirit of the WTO and recommit to the broadest possible use of markets to drive innovation, job creation, and economic growth. While IPR remains the number one issue in our bilateral economic relationship . . . , the continued and expanding use of government intervention and industrial policies . . . have the potential to create even sharper frictions in bilateral economic relations than IPR.

Developments evidencing this reduced momentum for economic reforms over the past year make clear that China has not yet fully institutionalized market mechanisms, and that some Chinese government agencies and officials have not yet fully embraced the key WTO principles of market access, non-discrimination, national treatment and transparency. A lack of consensus within China's government and competing Chinese government priorities – including differences in views and approaches among China's central, provincial and local governments – have also contributed to the reduced momentum for economic reforms, as have systemic rule of law problems.

Recognizing these challenges, USTR announced, in a "top-to-bottom" review of U.S.-China trade relations issued earlier this year, that it would adopt a dual-track approach to resolving its WTO concerns. The United States will continue to seek cooperative and pragmatic resolutions through bilateral dialogue with China, including the Joint Commission on Commerce and Trade (JCCT) as well as ad hoc bilateral meetings and a variety of sector-specific dialogues. However,

when bilateral dialogue fails to succeed in addressing U.S. concerns, the United States will not hesitate to exercise its WTO rights through the initiation of dispute settlement against China, as it would with any other mature WTO trading partner.

The United States achieved some important successes through bilateral dialogue in 2006, including at a JCCT meeting in April. At that meeting, China made several commitments related to IPR protection and enforcement, and it also committed to eliminate duplicative testing and certification requirements applicable to imported medical devices, to make adjustments to its registered capital requirements for telecommunications service providers, and to finalize a protocol allowing the resumption of trade in U.S. beef and beef products. China also reaffirmed past commitments to technology neutrality for 3G telecommunications standards and to ensuring that foreign express couriers would not be negatively impacted by new rules in the postal area. In addition, China committed to commence, by no later than December 31, 2007, formal negotiations to join the WTO's Government Procurement Agreement. Since the JCCT meeting in April, the United States has been working with China to make sure that it implements all of these commitments.

However, to date, other issues have evaded bilateral consensus, despite extensive dialogue. Issues like IPR criminal enforcement thresholds, certain market access concerns and WTO prohibited subsidies have resisted resolution in 2006. Although the United States has been making earnest efforts to resolve these concerns through bilateral discussions, it will have to pursue other options if the bilateral approach is not fruitful.

U.S. preparation for the pursuit of formal WTO dispute settlement has already facilitated resolution of one dispute in 2006, and another Chinese measure is now the subject of formal WTO dispute settlement. In January 2006, after the United States informed China that it would be filing a formal request for WTO consultations in a challenge to antidumping duties that China had imposed on imports of unbleached kraft linerboard from the United States, China rescinded the antidumping duties. This result enabled U.S. industry to obtain a faster resolution to this problem than would have been possible if the dispute settlement process had needed to run its course. In March 2006, the United States, acting in coordination with the European Communities (EC) and Canada, commenced a WTO dispute settlement case challenging Chinese rules that brought back prohibited local content requirements in the auto sector through the imposition of measures that discriminated unfairly against imported auto parts. More recently, in November 2006, the United States informed China that it would be filing a WTO consultations request with regard to certain IPR enforcement issues, but then agreed to hold off, with the support of U.S. industry, when China asked for further bilateral discussions.

Overall, several areas continue to cause particular concern for the United States and U.S. industry, in terms of China's full adherence to its WTO commitments. The key concerns in each of these areas are summarized below.

## **Intellectual Property Rights**

Since its accession to the WTO, China has been able to put in place a relatively good set of laws and regulations aimed at protecting the intellectual property rights of domestic and foreign right holders. However, some critical measures – such as those establishing high thresholds for criminal prosecution – still need to be revised, and China’s enforcement of its laws protecting the intellectual property rights covered by the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (the TRIPS Agreement) has often been ineffective. With many in U.S. industry reporting no significant reduction in IPR infringement levels again in 2006, counterfeiting and piracy in China remain at unacceptably high levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy.

In 2006, the Administration continued to place the highest priority on improving IPR enforcement in China. One key focus of the United States’ bilateral engagement with China continued to be on working with China to improve its IPR enforcement regime so that significant reductions in IPR violations in China could be realized. The United States sought to build on its earlier engagement with China at the April 2004 and July 2005 JCCT meetings, and it placed China on the Special 301 “Priority Watch” list in 2005. Through the JCCT process in 2006, which included a meeting in April, China agreed to take some immediate steps to address particular problems and committed to take additional future actions. During the run-up to the JCCT meeting, China took enforcement actions against plants that produce pirated optical discs, and it issued new rules that require computers to be pre-installed with licensed operating system software. At the JCCT meeting itself, China committed to ensure the legalization of software used in Chinese enterprises, to pursue increased cooperation to combat pirated goods displayed at trade fairs in China, and to intensify efforts to eliminate infringing products at major consumer markets in China. The two sides further agreed that they would increase cooperation between their respective law enforcement and customs authorities and that the United States would provide China with additional technical assistance to assist it in fully implementing the World Intellectual Property Organization (WIPO) Internet treaties, which address the increasingly important area of copyright protection over electronic information networks.

Despite this progress, China continues to deflect calls from the United States and other WTO members for better utilization of criminal remedies to combat rampant IPR infringement in China, claiming that its combination of administrative, civil and criminal enforcement is increasingly effective. The available statistics on continuing massive IPR infringement in China raise obvious questions about this claim. The United States and other WTO members have been unable to review details concerning China’s administrative, civil and criminal enforcement system because of China’s lack of transparency. In an attempt to better assess this situation, the United States, Japan and Switzerland submitted requests to China under Article 63.3 of the TRIPS Agreement in October 2005, seeking detailed information from China on its IPR enforcement efforts over the prior four years. China has provided only limited information in response, hampering the United States’ ability to evaluate what steps are being taken to try to address the rampant IPR infringement found throughout China.

The United States remains committed to working constructively with China to significantly reduce IPR infringement levels in China and continues to devote extra staff and resources, both in Washington and in Beijing, to address the many aspects of this issue. At the same time, when bilateral discussions prove unable to resolve key differences on particular issues, the United States remains prepared to take action, including WTO dispute settlement, where appropriate, to ensure that China develops and implements an effective system of IPR enforcement, as required by the TRIPS Agreement.

### **Industrial Policies**

China has continued to resort to industrial policies that limit market access for non-Chinese origin goods and foreign service providers, and that provide substantial government resources to support Chinese industries and increase exports. In some cases, the objective of these policies seems to be to promote the development of Chinese industries that are higher up the economic value chain than the industries that make up China's current labor-intensive base. In other cases, China appears simply to be protecting less competitive domestic industries.

In 2006, examples of these industrial policies remain readily evident. One obvious example is China's regulations on auto parts tariffs, issued last year, which serve to prolong prohibited local content requirements for motor vehicles – a matter that is currently the subject of a WTO dispute brought by the United States, the EC and Canada. Other examples include the telecommunications regulator's continuing interference in commercial negotiations over royalty payments to intellectual property rights holders in the area of 3G standards, the continuing pursuit of unique national standards in many areas of high technology that could lead to the extraction of technology or intellectual property from foreign right holders, a July 2005 industrial policy that calls for the state's management of nearly every major aspect of China's steel industry, export restrictions on raw materials like coke, and excessive government subsidization benefitting a range of domestic industries in China. Worrysome new measures over the past year include new requirements for state control of "critical" equipment manufacturers, revised rules for foreign mergers and acquisitions that confer broad and vaguely defined powers on the government to block investments in a range of industries, and plans to steer government purchases to domestic manufacturers to promote innovation in Chinese enterprises. Some of these policies appear to conflict with China's WTO commitments in the areas of market access, national treatment and technology transfer, among others.

The United States and China made little progress in resolving U.S. concerns regarding these industrial policies in 2006. China did reaffirm its commitment to technology neutrality for 3G telecommunications standards, but serious disagreements over a number of other industrial policies remain, including China's continued use of prohibited subsidies. The United States will again press China on these matters in 2007 and will take further appropriate actions seeking elimination of these policies, including WTO dispute settlement, where appropriate.

## **Trading Rights and Distribution Services**

China was scheduled to phase in two key WTO commitments by December 11, 2004. These commitments called for full liberalization of trading rights – the right to import and export – and distribution services, including wholesale and retail services, franchising services and related services. Although delay and confusion initially characterized China's efforts to implement its distribution services commitments, China was able to largely overcome these problems in 2006, prodded by consistent and determined U.S. engagement. U.S. companies and individuals in most sectors are now not only able to import and export goods in China directly without having to use a middleman, but are also able to establish their own distribution networks within China. Many in U.S. industry consider trading rights and distribution services to be "the most important of the WTO commitments China has so far implemented," according to one trade association with broad representation.

Nevertheless, some problems still remain in critical areas. In particular, China continues to maintain import and distribution restrictions on several types of products, including foreign publications such as books, periodicals and audio and video products, in apparent contravention of China's trading rights and distribution services commitments. These restrictions reduce and delay market access for these copyrighted products, creating additional incentives for infringement in China's market. Another key area involves China's commitment to open its market for sales away from a fixed location, also known as "direct selling." Initially delayed, China's implementation of this commitment has since proceeded slowly and has subjected foreign direct sellers to unwarranted restrictions on their business operations. The United States will continue to pursue these important issues in 2007 to ensure that China fully meets its commitments and will take further appropriate actions seeking the revision or elimination of problematic policies, including through WTO dispute settlement, where appropriate.

## **Agriculture**

U.S. agricultural exports to China in 2005 totaled \$5.2 billion, with China becoming the United States' fourth largest agricultural export market. To date, 2006 has been an even more successful year. U.S. exports of agricultural commodities, particularly cotton and wheat, have continued to increase dramatically in recent years, and U.S. exports of soybeans continued to perform strongly – on target in 2006 to well exceed \$2 billion for the fourth year in a row, with China remaining the leading export destination for U.S. soybeans.

While U.S. exports of agricultural commodities largely fulfill the potential envisioned by U.S. negotiators during the years leading up to China's WTO accession, China's WTO implementation in the agricultural sector continues to be plagued by uncertainty, largely because of selective intervention in the market by China's regulatory authorities. As in past years, capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary (SPS) standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities, who require as much predictability and transparency as possible in

order to preserve margins and reduce the already substantial risks involved in agricultural trade. As a result, trade with China in the agricultural sector remains among the least transparent and predictable of the world's major markets.

In 2007, the United States will continue to pursue vigorous bilateral engagement with China in order to obtain progress on its outstanding concerns, particularly with regard to China's ban on the importation of U.S. beef and beef products. This issue is emblematic of the problems that U.S. exporters face with non-transparent application of SPS measures, many of which appear to lack scientific bases and impeded market access for many U.S. agricultural products in 2006, particularly exports of consumer-ready and value-added products.

### **Services**

Overall, the United States enjoyed a substantial surplus in trade in services with China in 2006, as in prior years, and the market for U.S. service providers in China remains promising. However, in some sectors, the expectations of the United States and other WTO members when agreeing to China's commitments to increase market access and remove restrictions have still not been fully realized. Chinese regulatory authorities continue to frustrate efforts of U.S. providers of banking, insurance, motor vehicle financing, telecommunications, construction and engineering, legal and other services to achieve their full market potential in China through the use of an opaque regulatory process, overly burdensome licensing and operating requirements, and other means.

In 2006, U.S. engagement led to some positive developments. China's insurance regulators continued to participate in a dialogue on insurance issues, and China made a commitment at the April 2006 JCCT meeting to adjust capital requirements for telecommunications services providers, although it has been slow to follow through on that commitment. China also reiterated its commitments at the April 2004 and July 2005 JCCT meetings not to negatively affect the regulatory environment for foreign providers of express delivery services via new postal rules being drafted.

At the same time, some new concerns arose in 2006. Xinhua, the Chinese state news agency, issued rules in September 2006 imposing new restrictions on foreign providers of financial information services, in apparent contravention of China's WTO obligations. In addition, a variety of problematic proposals were circulated by Chinese regulators as China prepared to implement important financial services commitments scheduled to be phased in by December 11, 2006. In 2007, the United States will continue to engage China and will closely monitor developments in these areas in an effort to ensure that China fully adheres to its commitments.

## **Transparency**

One of the fundamental principles of the WTO Agreement, reinforced throughout China's WTO accession agreement, is transparency. Adherence to this principle permits markets to function effectively and reduces opportunities for officials to engage in trade-distorting practices behind closed doors. While China's transparency commitments in many ways require a profound historical shift, China made important strides to improve transparency across a wide range of national and provincial authorities during the first four years of its WTO membership, although two shortcomings stood out. By the beginning of 2006, China had still not adopted a single official journal for publishing all trade-related measures, and it had yet to regularize the use of notice-and-comment procedures for new or revised trade-related measures prior to implementation, despite having made commitments to do so. In March 2006, after the United States elevated this issue to the JCCT level, China finally adopted a single official journal, although much work remains for China to ensure full participation by all relevant government entities. The United States has also pushed China to adopt a mandatory notice-and-comment practice, but, to date, this practice remains optional in China. As a result, as 2006 was drawing to a close, many of China's regulatory regimes continued to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession.

## **Conclusion**

In 2007, the Administration will continue its relentless efforts to ensure China's full implementation of specific WTO commitments and full adherence to China's ongoing obligations as a WTO member, with particular emphasis on reducing IPR infringement levels in China, and on pressing China to make greater efforts to institutionalize market mechanisms and make its trade regime more predictable and transparent. Throughout this process, the Administration will use a dual-track approach. The Administration remains committed to working cooperatively and pragmatically with China to ensure that the benefits of China's WTO membership are realized by U.S. workers, businesses, farmers, service providers and consumers and that problems in our trade relationship are appropriately resolved. The new, high-level U.S.-China Strategic Economic Dialogue, scheduled to begin in December 2006, demonstrates that commitment and promises to provide a useful framework for understanding and supporting, at a broader level, key bilateral problem-solving efforts, such as the JCCT process and other bilateral dialogues. When bilateral dialogue is not successful, however, the Administration will not hesitate to employ the full range of enforcement tools available as a result of China's accession to the WTO, whether it be the dispute settlement procedures at the WTO or the strict enforcement of U.S. trade laws to ensure that U.S. interests are not harmed by unfair trade practices.



## **BACKGROUND**

### **China's WTO Accession Negotiations**

In July of 1986, China applied for admission to the WTO's predecessor, the General Agreement on Tariffs and Trade (GATT). The GATT formed a Working Party in March of 1987, composed of all interested GATT contracting parties, to examine China's application and negotiate terms for China's accession. For the next eight years, negotiations were conducted under the auspices of the GATT Working Party. Following the formation of the WTO on January 1, 1995, a successor WTO Working Party, composed of all interested WTO members, took over the negotiations.

Like all WTO accession negotiations, the negotiations with China had three basic aspects. First, China provided information to the Working Party regarding its trade regime. China also updated this information periodically during the 15 years of negotiations to reflect changes in its trade regime. Second, each interested WTO member negotiated bilaterally with China regarding market access concessions and commitments in the goods and services areas, including, for example, the tariffs that would apply on industrial and agricultural goods and the commitments that China would make to open up its market to foreign services suppliers. The most trade liberalizing of the concessions and commitments obtained through these bilateral negotiations were consolidated into China's Goods and Services Schedules and apply to all WTO members. Third, overlapping in time with these bilateral negotiations, China engaged in multilateral negotiations with Working Party members on the rules that would govern trade with China. Throughout these multilateral negotiations, U.S. leadership in working with China was critical to removing obstacles to China's WTO accession and achieving a consensus on appropriate rules commitments. These commitments are set forth in China's Protocol of Accession and an accompanying Report of the Working Party.

WTO members formally approved an agreement on the terms of accession for China on November 10, 2001, at the WTO's Fourth Ministerial Conference, held in Doha, Qatar. One day later, China signed the agreement and deposited its instrument of ratification with the Director-General of the WTO. China became the 143rd member of the WTO on December 11, 2001.

China's Protocol of Accession, accompanying Working Party Report and Goods and Services Schedules are available on the WTO's website ([www.wto.org](http://www.wto.org)).

### **Overview of China's WTO Commitments**

In order to accede to the WTO, China had to agree to take concrete steps to remove trade barriers and open its markets to foreign companies and their exports from the first day of accession in virtually every product sector and for a wide range of services. Supporting these steps, China also agreed to undertake important changes to its legal framework, designed to add transparency and predictability to business dealings.

Like all acceding WTO members, China also agreed to assume the obligations of more than 20 existing multilateral WTO agreements, covering all areas of trade. Areas of principal concern to the United States and China's other trading partners, as evidenced by the accession negotiations, included the core principles of the WTO, including most-favored nation treatment, national treatment, transparency and the availability of independent review of administrative decisions. Other key concerns could be found in the areas of agriculture, sanitary and phytosanitary measures, technical barriers to trade, trade-related investment measures, customs valuation, rules of origin, import licensing, antidumping, subsidies and countervailing measures, trade-related aspects of intellectual property rights and services. For some of its obligations in these areas, China was allowed minimal transition periods, where it was considered necessary.

Even though the terms of China's accession agreement are directed at the opening of China's market to WTO members, China's accession agreement also includes several mechanisms designed to prevent or remedy injury that U.S. or other WTO members' industries and workers might experience based on import surges or unfair trade practices. These include a unique, China-specific safeguard provision allowing a WTO member to restrain increasing Chinese imports that disrupt its market (available for 12 years, running from the date of China's WTO accession), a special textile safeguard (available for 7 years) and the continued ability to utilize a special non-market economy methodology for measuring dumping in anti-dumping cases against Chinese companies (available for 15 years). The Administration is committed to maintaining the effectiveness of these mechanisms for the benefit of affected U.S. businesses, workers and farmers.

With China's consent, the WTO also created a special multilateral mechanism for reviewing China's compliance on an annual basis. Known as the Transitional Review Mechanism, this mechanism operates annually for 8 years after China's accession, with a final review by year 10.

## **STATUS OF CHINA'S WTO COMPLIANCE EFFORTS**

### **Trading Rights and Distribution Services**

Within the context of China's WTO commitments, the concept of "trading rights" includes two elements, i.e., the right to import goods (into China) and the right to export goods (from China). It does not include the right to sell goods within China, as that right is governed by separate commitments principally relating to "distribution services" set forth in China's Services Schedule (see the Distribution Services section below). In the global business world, trading rights and distribution services are fundamentally interrelated, and often an enterprise will need both of them to carry out its business plan.

China's commitments on trading rights and distribution services are critically important. They offer the potential to enormously expand the scope of business opportunities available to a wide range of U.S. and other foreign industries doing business, or seeking to do business, in China. These commitments were scheduled to be fully phased in (subject to a few product exceptions) by December 11, 2004, when existing restrictions on companies already invested in China were to be removed, and U.S. companies were to be fully able to import and sell goods in China or export goods from China. It is envisioned that these changes will enhance the efficiency with which a wide range of U.S. companies can distribute and provide related logistics services for imported or domestically produced goods in China, while also enabling U.S. companies to integrate their China operations more easily with their global networks.

Overall, China remains in basic compliance with its trading rights commitments, although one significant problem area involves the importation of foreign publications such as books, periodicals and audio and video products, which China still reserves for state trading. Meanwhile, China has made substantial progress in implementing its distribution services commitments, although some technical challenges remain, and the distribution of some products, like foreign publications, remains restricted. In addition, the area of direct selling, or sales away from a fixed location, remains problematic.

### ***Trading Rights***

In the trading rights area, until shortly before its WTO accession, China severely restricted the number and types of enterprises that could import or export, and it also restricted the products that a particular enterprise could import or export. For the most part, China confined trading rights to certain state-owned manufacturing and trading enterprises, which could import or export goods falling within their approved scopes of business. China also granted trading rights to certain foreign-invested enterprises, allowing them to import inputs for their production purposes and export their finished products.

In its accession agreement, responding to concerns raised by members of the WTO working party on China's accession, China committed to substantial liberalization in the area of trading rights. China agreed to eliminate its system of examination and approval of trading rights and make full

trading rights automatically available for all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships, within three years of its accession, or by December 11, 2004, the same deadline for China to eliminate most restrictions in the area of distribution services. The only exceptions applied to products listed in an annex to China's accession agreement, such as grains, cotton and tobacco, for which China reserved the right to engage in state trading. China also agreed to take a number of liberalization steps during the years prior to its adoption of an automatic trading rights system, including trading rights for Chinese enterprises immediately upon China's accession, followed by trading rights for joint ventures with minority foreign ownership within one year after China's accession and trading rights for joint ventures with majority foreign ownership within two years after China's accession.

As previously reported, during the phase-in period, China timely implemented its commitments relating to Chinese enterprises, but fell behind in implementing the commitments for joint ventures with minority foreign ownership (scheduled for implementation by December 11, 2002) and joint ventures with majority foreign ownership (scheduled for implementation by December 11, 2003). It was not until April 2004, after the United States had made trading rights one of its priority issues during the run-up to the April 2004 JCCT meeting, that China finally began to take steps to implement its commitments more fully. Shortly before that meeting, the National People's Congress issued a revised *Foreign Trade Law*. It provided for trading rights to be automatically available through a registration process for all domestic and foreign entities and individuals, effective July 1, 2004, almost six months ahead of the scheduled full liberalization required by China's accession agreement. In June 2004, MOFCOM issued implementing rules setting out the procedures for registering as a foreign trade operator in time for the new registration process to be operational on the July 1 effective date.

In 2006, as in 2005, U.S. companies continued to report few problems with the new trading rights registration process. For many U.S. companies, however, having trading rights – and, in particular, the right to import – is only meaningful when coupled with the right to distribute goods within China, an area in which China's implementation progress had been slower until MOFCOM began allowing provincial-level authorities to grant distribution licenses earlier this year.

However, China has not yet implemented its trading rights commitments insofar as they relate to the importation of books, newspapers, periodicals, electronic publications and audio and video products. Under the terms of China's accession agreement, China's trading rights commitments apply fully to these products, as they are not among the products for which China reserved the right to engage in state trading. As a result, trading rights for these products should have been automatically available to all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals as of December 11, 2004. Nevertheless, China continues to wholly reserve the right to import books, newspapers, periodicals, electronic publications and audio and video products to state trading enterprises, as reflected in the *Procedures for the Examination and Approval of Establishment of Publication Importation Entities*, issued by the General Administration of Press and Publication (GAPP) in December

2005, the *Several Opinions on Canvassing Foreign Investment into the Cultural Sector*, issued by the State Council in April 2005, the *Catalogue for the Guidance of Foreign Investment Industries*, issued by the National Development and Reform Commission (NDRC) in November 2004, and the *Administrative Regulations on Publishing*, issued by the State Council in December 2001.

In 2005, U.S. publishers began to express concern about China's failure to implement its commitment to allow foreign enterprises to import books, newspapers and periodicals. The United States raised this matter in bilateral meetings with China and at the WTO during the transitional reviews before the Committee on Market Access in October 2005 and before the Council for Trade in Goods in November 2005.

In 2006, U.S. producers and distributors of electronic publications and audio and video products began to express concern about having to continue to use Chinese middlemen to import (and distribute) their products well after China should have implemented its trading rights (and distribution services) commitments. Beginning in May 2006, the United States used a series of high-level and technical-level bilateral meetings in Beijing to raise the profile of its concerns, addressing not only books, newspapers and periodicals, but also electronic publications and audio and video products. The United States also raised its concerns at the WTO, both during China's April 2006 Trade Policy Review and during the transitional reviews before the Committee on Market Access and the Council for Trade in Goods, held in October and November 2006.

To date, China has maintained that it can continue to preclude foreign enterprises from importing books, newspapers, periodicals, electronic publications and audio and video products (and continue to impose various restrictions on foreign enterprises' distribution of these products within China) based on the general exception for the protection of the public morals in Article XX of GATT 1994, despite the fact that these restrictions are not necessary to achieve China's underlying objectives of monitoring and censoring the contents of these products. The United States will continue to press China on these issues and will take further appropriate actions seeking elimination of China's restrictions in 2007.

### ***Distribution Services***

Prior to its WTO accession, China generally did not permit foreign enterprises to distribute products in China, i.e., to provide wholesaling, commission agents', retailing or franchising services or to provide related services, such as repair and maintenance services. These services were largely reserved to Chinese enterprises, although some foreign-invested enterprises were allowed to engage in distribution services within China under certain circumstances. For example, joint ventures had the right to supply wholesaling and retailing services for the goods they manufacture in China since the issuance of the *Regulations for the Implementation of the Law on Chinese-Foreign Equity Joint Ventures* by MOFCOM's predecessor, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), in December 1987. Similarly, wholly

foreign-owned enterprises had this same right under the *Detailed Rules for the Implementation of the Law on Wholly Foreign-Owned Enterprises*, issued by MOFTEC in April 2001.

In its accession agreement, China committed to eliminate national treatment and market access restrictions on foreign enterprises providing these services through a local presence within three years of China's accession (or by December 11, 2004), subject to limited product exceptions. In the meantime, China agreed to progressively liberalize its treatment of wholesaling services, commission agents' services and direct retailing services (except for sales away from a fixed location), as described below.

Overall, China has made substantial progress in implementing its distribution services commitments. While delays in implementation and confusion over eligibility characterized much of 2005, these problems largely disappeared in 2006 after China's Ministry of Commerce (MOFCOM) began allowing provincial-level authorities to grant distribution licenses, although some technical challenges remain, and the distribution of some products, like foreign publications, remains restricted. In addition, the area of direct selling, or sales away from a fixed location, remains problematic, with limited progress achieved since the issuance of implementing rules in August 2005.

In 2007, the United States will continue to closely monitor how MOFCOM and relevant provincial and municipal authorities exercise their licensing approval authority, particularly in the area of direct selling. The United States will work to ensure that the approval systems operate expeditiously, in a non-discriminatory manner and without creating any new trade barriers.

The United States will also continue to work closely with U.S. companies as they seek to provide the range of distribution services in China. Inevitably, U.S. and other foreign companies will face challenges, particularly with regard to the creation of nationwide distribution networks in China. Currently, distribution networks remain highly fragmented in China, as there are no Chinese distribution companies with nationwide networks and no Chinese distribution company holds a market share greater than two percent, due largely to infrastructure limitations and restrictive provincial and local requirements. Nevertheless, the central government has a strong interest in addressing these impediments and developing nationwide distribution networks, which will foster economic and employment growth and help revitalize rural areas in China.

In addition, the United States will continue to monitor how MOFCOM and relevant provincial and local authorities apply a provision in the April 2004 distribution services regulations requiring wholesaling and retailing enterprises to comply with municipal commercial development rules and will work to ensure that any requirements are applied on a national treatment basis. This provision, which does not appear to apply to domestic enterprises, would seem to reinforce the *Notice on Strengthening the Planning Work for Urban Commercial Networks*, issued by MOFTEC in January 2003. That notice had stipulated that cities without approved commercial development plans could not apply to the central government authorities for approval of foreign-invested projects in the distribution services sector. The United States

has also begun to monitor a troubling proposal made by MOFCOM with regard to retail distribution in August 2006. If adopted, this proposal could make it easier for cities to reject applications for approval of new retail outlets on the ground that it would “disrupt” existing local commerce.

The United States will also work closely with U.S. industry in 2007 in evaluating and addressing recently issued regulations intended by China to implement its commitments to open up its wholesale distribution market for crude oil and processed oil by December 11, 2006. These regulations appear to create high thresholds and other potential impediments to market entry for foreign enterprises.

#### Wholesaling Services and Commission Agents’ Services

China committed that, immediately upon accession, it would permit Chinese-foreign joint ventures and wholly foreign-owned enterprises to distribute at the wholesale level within China any goods that they make in China, without any market access or national treatment limitations. Within one year after accession (or by December 11, 2002), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents’ services within China for almost all goods, whether made in China or imported, through joint ventures with minority foreign ownership. Excepted goods included salt, tobacco, chemical fertilizers, processed oil and crude oil as well as books, newspapers, magazines, pharmaceutical products, pesticides and mulching films. Within two years after accession (or by December 11, 2003), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents’ services within China through majority foreign-owned joint ventures, subject to the same exceptions. Within three years after accession (or by December 11, 2004), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents’ services within China through wholly foreign-owned enterprises. In addition, by this time, the exceptions for books, newspapers, magazines, pharmaceutical products, pesticides and mulching films were to be eliminated. The exceptions for chemical fertilizers, processed oil and crude oil (but not salt and tobacco) are to be eliminated within five years after accession (or by December 11, 2006).

As previously reported, China fell behind in implementing its commitments regarding wholesaling services and commission agents’ services insofar as they related to joint ventures with minority foreign ownership (scheduled for implementation by December 11, 2002) and joint ventures with majority foreign ownership (scheduled for implementation by December 11, 2003). It was not until April 2004, after the United States had made distribution services – including wholesale services – one of its priority issues during the run-up to the April 2004 JCCT meeting, that China finally began to take steps to implement its commitments more fully. Shortly before that meeting, MOFCOM issued the *Measures on the Management of Foreign Investment in the Commercial Sector*, superseding the *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*, which had been in force since June 1999. These regulations belatedly lifted market access and national treatment restrictions on joint ventures engaging in wholesale services effective June 2004. The regulations also extended this liberalization to wholly foreign-owned enterprises and removed product exceptions for books,

newspapers, magazines, pharmaceutical products, pesticides and mulching films (but not for chemical fertilizers, processed oil, crude oil, salt and tobacco) as of the scheduled phase-in date of December 11, 2004. The regulations required enterprises to obtain central or provincial-level MOFCOM approval before providing these services. In addition, they appeared to set relatively low qualifying requirements, as enterprises needed only to satisfy the relatively modest capital requirements of the *Company Law* rather than the high capital requirements found in many other services sectors.

While these regulations were welcome, MOFCOM was very slow to implement them. Initially, MOFCOM did not issue any guidance regarding how its approval system would operate, and the application process remained opaque. In most instances, the application process turned into a protracted negotiation, as the central and local approving authorities were still in the process of determining the appropriate procedures and documentation requirements. When approvals were issued, moreover, the central and local approving authorities imposed a variety of restrictions, such as limits on the scope of products that could be distributed and limits on the specific services that could be supplied. Registered capital requirements also varied, as MOFCOM regularly demanded that U.S. and other foreign retailers satisfy registered capital requirements ranging from \$1 million to more than \$2 million, far in excess of the minimum registered capital requirement of RMB 300,000 (\$37,500) found in the *Company Law*.

Meanwhile, a separate set of problems plagued existing enterprises seeking to expand their business scope to include wholesale distribution. The Chinese authorities rarely issued licensing approvals for these enterprises, in part because the Chinese authorities were sorting out historical tax treatment and Free Trade Zone (FTZ) issues. The Chinese authorities did issue some approvals for the establishment of new wholesale distribution enterprises, but this route did not make business sense for many enterprises already established in China.

By June 2005, the Chinese authorities had begun to make progress in resolving many of the problems that had plagued the application and approval process, including how it would handle the tax and FTZ issues that had stalled many enterprises' applications. During the run-up to the July 2005 JCCT meeting, as the United States made full implementation of China's wholesale (and retail) distribution services commitments an issue of high priority, the Chinese authorities reduced much of the backlog of distribution license applications. In addition, in July 2005, MOFCOM and the General Administration of Customs (Customs Administration) issued the *Circular on Issues Concerning the Trade Administration of Bonded Zones and Bonded Logistics Parks*, which clarified the handling of applications from enterprises located in FTZs. At the July 2005 JCCT meeting, China committed to improve the transparency of the application and approval process. Consistent with this commitment, in September 2005, MOFCOM issued the *Application and Approval Guidelines for Foreign Investments*, which clarified many aspects of the application and approval process. Some improvements subsequently took place in the application and approval process, but it was not until MOFCOM issued the *Notice on Entrusting National Economic and Technological Development Zones with the Authority to Approve Foreign-Funded Distribution Firms and International Forwarding Agents* in February 2006 that the problems with the application and approval process largely disappeared. With the issuance



of that measure, MOFCOM devolved the right to grant distribution licenses from the central authorities to provincial-level authorities, making the application and approval process more efficient and less time-consuming, although some technical challenges remain with regard to, for example, manufacturing enterprises seeking to expand the scope of their business to include distribution activities.

These developments have enabled U.S. companies to improve the efficiency of their China supply chain management, and as a result many of them are restructuring their legal entities to integrate their China operations into their global business more fully and efficiently. At the same time, U.S. companies in some industries continue to have concerns with regard to product and services restrictions that China has yet to remove.

U.S. industry remains seriously concerned about continuing restrictions on the rights of foreign enterprises to engage in wholesale (and retail) distribution of books, newspapers, periodicals, electronic publications and audio and video products. Some measures, such as the April 2004 distribution services regulations, purport to allow foreign enterprises to engage in wholesale (and retail) distribution of these products. However, a host of other measures appear to impose market access or national treatment limitations, such as the State Council's April 2005 *Several Opinions on Canvassing Foreign Investment into the Cultural Sector*, NDRC's November 2004 *Catalogue for the Guidance of Foreign Investment Industries*, the *Provisions on the Administration of the Publication Market*, issued by GAPP in June 2004, the *Rule on Management of Foreign-Invested Book, Magazine and Newspaper Distribution Enterprises*, issued by GAPP and MOFTEC in March 2003, and the *Administrative Regulations on Electronic Publications*, issued by GAPP in December 1997. Under these measures, for some of the products at issue, distribution is limited to Chinese state-owned enterprises. For others, only Chinese-foreign joint ventures with minority foreign ownership are permitted to engage in distribution or foreign enterprises face restrictive requirements not imposed on domestic enterprises.

Working with U.S. industry, the United States first sought to clarify the rights of foreign enterprises with regard to books, newspapers and periodicals through bilateral discussions with China in 2005 and in connection with the transitional reviews before the Council for Trade in Services in September 2005 and the Council for Trade in Goods in November 2005. The United States expanded and intensified its engagement beginning in May 2006, using a series of high-level and technical-level bilateral meetings in Beijing to raise the profile of its concerns, addressing the restrictions on not only books, newspapers and periodicals, but also electronic publications and audio and video products. The United States also raised its concerns at the WTO, both during China's April 2006 Trade Policy Review and during the transitional review before the Council for Trade in Services, held in November 2006.

To date, as in the area of trading rights, China has maintained that it can continue to impose restrictions on foreign enterprises' distribution of books, newspapers, periodicals, electronic publications and audio and video products within China based on the general exception for the protection of the public morals in Article XX of GATT 1994, despite the fact that these

restrictions are not necessary to achieve China's underlying objectives of monitoring and censoring the contents of these products. The United States is continuing to press China on these issues and will take further actions seeking elimination of China's restrictions, including the initiation of WTO dispute settlement if appropriate.

China began to implement several measures governing the distribution of automobiles by foreign enterprises in 2005, including the *Implementing Rules for the Administration of Brand-Specific Automobile Dealerships*, jointly issued by MOFCOM, the NDRC and the State Administration for Industry and Commerce (SAIC) in February 2005. In November 2005 the NDRC followed up with the *Rules for Auto External Marks*, and in January 2006 MOFCOM issued the *Implementing Rules for the Evaluation of Eligibility of Auto General Distributors and Brand-specific Dealers*. While U.S. industry have generally welcomed these measures, they do contain some restrictions on foreign enterprises that may not be applied to domestic enterprises. As in 2006, the United States will closely monitor how China applies these measures in 2007 in an effort to ensure that foreign enterprises are not adversely affected by these restrictions.

China delayed the implementation of its wholesale distribution services commitments with regard to pharmaceuticals, despite the fact that the exception for pharmaceuticals contained in China's accession agreement expired as of December 11, 2004. Although the April 2004 regulations indicated that separate regulations would be issued for the pharmaceuticals sector, China did not issue any further regulations and continued to require foreign pharmaceutical companies to sell their finished products through Chinese wholesalers (after hiring Chinese importers to bring their finished products into the country) through the remainder of 2004 and the first half of 2005. China decided in the last half of 2005 to begin allowing the acceptance of applications from foreign pharmaceutical companies for wholesale distribution licenses under the April 2004 regulations and the State Food and Drug Administration's *Rules on the Management of Drug Business Licenses*. Since then, U.S. and other foreign pharmaceutical companies have been able to obtain wholesale distribution licenses, although it appears that some provincial-level authorities have not yet begun issuing these licenses because of uncertainty generated by the provision in the April 2004 regulations indicating that MOFCOM would be issuing separate regulations covering pharmaceuticals. At the same time, despite overall progress in this area, many other restrictions affecting the pharmaceuticals sector make it difficult for foreign pharmaceutical companies to realize the full benefits of China's wholesale distribution commitments. The United States is continuing to engage the Chinese regulatory authorities in these areas as part of an effort to promote comprehensive reform of China's healthcare system and to reduce the unnecessary – and, in some cases, apparently WTO-inconsistent – trade barriers that they face.

U.S. industry remains concerned about the uncertainty created by the provision in the April 2004 regulations that allows the local approving authorities to withhold wholesale (and retail) distribution license approvals when, as is the case in most cities, urban commercial network plans have not yet been formulated. This provision could operate as a *de facto* restriction on the operations of foreign wholesalers (and retailers). The United States will continue to monitor developments in this area closely in 2007.

Meanwhile, U.S. industry has become concerned about China's implementation of significant market-opening commitments, scheduled for December 11, 2006, designed to permit foreign enterprises to engage in wholesale distribution of crude oil and processed oil, e.g., gasoline. China's full implementation of these commitments would allow U.S. industry to begin to take advantage of China's earlier, partial opening of the retail distribution sector to foreign enterprises (discussed below in the Retailing Services section). However, in early December 2006, China issued regulations – without providing an opportunity for prior public comment – imposing high thresholds and other potential impediments on foreign enterprises seeking to enter the wholesale distribution sector, such as requirements relating to levels of storage capacity, pipelines, rail lines, docks and supply contracts. Based on reports that it received regarding earlier, selectively circulated drafts, the United States had pressed for the issuance of a draft for public comment and had highlighted the importance of full implementation of these commitments in bilateral meetings with China earlier this year and during the transitional review before the Council for Trade in Services, held in November 2006. In close consultation with U.S. industry, the United States will carefully assess the recently issued regulations and will continue to engage China in 2007 in an effort to ensure that U.S. industry realizes the full benefits of China's commitments in this sector.

#### Retailing Services

In addition to committing to permit Chinese-foreign joint ventures and wholly foreign-owned enterprises to distribute at the retail level within China any goods that they make in China without any market access or national treatment limitations, effective immediately upon China's WTO accession, China agreed to permit foreign service suppliers to supply retailing services for almost all goods, whether made in China or imported, through joint ventures with minority foreign ownership, subject to geographic restrictions (allowing China to limit market access to five Special Economic Zones and eight cities) and quantitative restrictions (allowing China to limit the number of joint ventures that could operate in six of the eight cities). Excepted goods include tobacco, chemical fertilizers, processed oil, pharmaceutical products, pesticides, mulching films, books, newspapers and magazines. The exceptions for the retailing of books, newspapers and magazines were to have been removed within one year after accession (or by December 11, 2002). Within two years after accession (or by December 11, 2003), China agreed to permit foreign service suppliers to supply retailing services through majority foreign-owned joint ventures, subject to the product exceptions set forth above. China also reserved the right to continue to impose the geographic and quantitative restrictions set forth above, although the geographic restrictions were to be eased, with market access being extended to all provincial capitals and two other cities. Within three years after accession (or by December 11, 2004), China agreed to permit foreign service suppliers to supply retailing services through wholly foreign-owned enterprises. In addition, by this time, all geographic and quantitative restrictions were to be eliminated, and the exceptions for pharmaceutical products, pesticides, mulching films and processed oil were also to be eliminated. The exceptions for chemical fertilizers (but not tobacco) are to be eliminated within five years after accession (or by December 11, 2006).

As previously reported, China fell behind in implementing its retailing services commitments for joint ventures with minority foreign ownership (scheduled for implementation upon China's accession) and joint ventures with majority foreign ownership (scheduled for implementation by December 11, 2003). In April 2004, following repeated bilateral and multilateral U.S. engagement (as described above in the Wholesaling Services and Commission Agents' Services section), MOFCOM issued the *Measures on the Management of Foreign Investment in the Commercial Sector*, which superseded the June 1999 *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*. These regulations belatedly lifted market access and national treatment restrictions on joint ventures engaging in retail services effective June 1, 2004, except for allowed geographic and quantitative restrictions and product exceptions for pharmaceuticals, pesticides, mulching films and processed oil. The regulations also extended this liberalization to wholly foreign-owned enterprises and removed all remaining geographic and quantitative restrictions as of the scheduled phase-in date of December 11, 2004. As in the wholesale area, the regulations require enterprises to obtain central or provincial-level MOFCOM approval before providing these services, and they appear to set relatively low qualifying requirements, including relatively modest capital requirements, although in practice foreign (but not domestic) retailers reportedly must meet higher capital requirements.

Many of the same problems that plagued the application and approval process in the wholesale area in 2005 also arose in the area of retailing services, and the United States repeatedly pressed China to accelerate and improve the implementation of its commitments, just as it did in the wholesale area. The changes that took place in the application and approval process in the run-up to and after the July 2005 JCCT meeting helped, but it was MOFCOM's issuance of the *Notice on Entrusting National Economic and Technological Development Zones with the Authority to Approve Foreign-Funded Distribution Firms and International Forwarding Agents* in February 2006 that helped resolve many of the problems with the application and approval process.

Nevertheless, U.S. industry continues to have concerns, particularly with regard to the provision in the April 2004 regulations allowing the approving authorities to withhold retail distribution license approvals when, as is the case in many cities, urban commercial network plans have not yet been formulated. It appears that China may be applying this provision in a discriminatory manner. In April 2006, MOFCOM issued a notice explaining that foreign-invested enterprises would not be granted approvals for projects in cities that had not yet finalized their urban commercial network plans, while it appears that domestic enterprises continue to receive approvals for their projects. The United States is seeking clarification on this issue and will continue to monitor developments in this area closely in 2007 in an effort to ensure that China fully implements its commitments.

Meanwhile, it continues to appear that China is not fully implementing its commitment to allow foreign enterprises to sell processed oil, e.g., gasoline, at the retail level. As explained above, China's retail services commitments initially did not apply to processed oil, as it was one of the excepted goods under China's Services Schedule. However, that exception expired on December 11, 2004, and by that time China committed to permit wholly foreign-owned enterprises to

operate gas stations. Instead, China insists that gas stations fall under the chain store provision in its Services Schedule, which permits only joint ventures with minority foreign ownership for “those chain stores which sell products of different types and brands from multiple suppliers with more than 30 outlets.” The ability of foreign enterprises to engage in retail distribution of processed oil will become particularly important once China fully implements its commitments to permit foreign enterprises to engage in wholesale distribution of crude oil and processed oil, required by December 11, 2006. The United States is working with U.S. industry to assess China’s recently issued regulations on wholesale distribution of crude oil and processed oil and will engage the Chinese government in 2007 in an effort to ensure that U.S. industry realizes the full benefits to which it is entitled in this sector.

### Franchising Services

As part of its distribution services commitments, China committed to permit the cross-border supply of franchising services immediately upon its accession to the WTO. It also committed to permit foreign enterprises to provide franchising services in China, without any market access or national treatment limitations, by December 11, 2004.

In December 2004, as previously reported, MOFCOM issued new rules governing the supply of franchising services in China, the *Measures for the Administration of Commercial Franchises*, effective February 2005. These rules raised a number of concerns. Of particular concern is a requirement that a franchiser own and operate at least two units in China for one year before being eligible to offer franchises in China. The business models of many U.S. franchising companies, including some large hotel chains, are adversely affected by this requirement because they do not own and operate units, instead relying exclusively on franchisees to distribute goods and services. The rules also impose high capital requirements and require broad and vague information disclosure by franchisers, with uncertain liability if these disclosure requirements are not met.

Together with U.S. industry, the United States expressed strong concern about these rules and urged China to reconsider them. The United States understands that the Legislative Affairs Office of the State Council and MOFCOM are now working on revisions to the rules. The United States will monitor developments in this area closely in 2007.

### Sales away from a fixed location

China first permitted direct selling in 1990, and numerous domestic and foreign enterprises soon began to engage in this business. In the ensuing years, however, serious economic and social problems arose, as so-called “pyramid schemes” and other fraudulent or harmful practices proliferated. China outlawed direct selling in 1998, although some direct selling companies were permitted to continue operating in China after altering their business models.

In its WTO accession agreement, China committed to lift market access and national treatment restrictions in the area of sales away from a fixed location, or direct selling, by December 11, 2004. China did not agree to any liberalization before that date.

As early as 2002, MOFCOM and SAIC began drafting regulations to implement China's direct selling commitment. Despite U.S. requests and the December 11, 2004 deadline for China to implement its direct selling commitment, the Chinese authorities did not make any drafts of these measures publicly available, instead only providing unofficial drafts to select direct selling enterprises. The Chinese authorities subsequently issued final versions of these measures – the *Measures for the Administration of Direct Selling* and the *Regulations on the Administration of Anti-Pyramid Sales Scams* – in August 2005, nine months late. In September 2006, after releasing a draft for public comment, MOFCOM issued the *Administrative Measures on the Establishment of Service Network Points for the Direct Sales Industry*, which clarified some aspects of the earlier measures.

The final versions of the August 2005 direct selling measures made some improvements to provisions apparently included in the earlier drafts, but they also contained several problematic provisions. For example, one provision essentially outlaws multi-level marketing practices allowed in every country in which the U.S. industry operates – reportedly 170 countries in all – by refusing to allow direct selling enterprises to pay compensation based on team sales, where upstream personnel are compensated based on downstream sales. The United States has pointed out that China could revise this provision to permit team-based compensation while still addressing its legitimate concerns about pyramid schemes. Other problematic provisions include a three-year experience requirement that only applies to foreign enterprises, not domestic ones, a cap on single-level compensation, restrictions on the cross-border supply of direct selling services and high capital requirements that may limit smaller direct sellers' access to the market. The new service center regulations also include vague requirements that could prove excessively burdensome for small and medium-sized direct sellers.

Working closely with U.S. industry, the United States immediately began urging the Chinese authorities to reconsider the problematic provisions in the direct selling measures, both bilaterally and during the transitional review before the Council for Trade in Services, held in September 2005. After the direct selling measures went into effect in December 2005, moreover, many companies began to apply for direct selling licenses but were confused by the opaque license review process. Despite MOFCOM's regulatory requirement that direct selling licenses be reviewed within ninety days, many foreign and domestic companies have waited for many months for MOFCOM and SAIC to review their license applications. Accordingly, the United States urged China to address the slow pace and lack of transparency in the licensing process, along with the problematic restrictions in the direct selling measures, during the run-up to the April 2006 JCCT meeting. In response, MOFCOM agreed to hold an informal dialogue with U.S. and other foreign industry representatives in the following months to better understand their concerns about the direct selling measures and to facilitate their efforts to navigate the application and approval process for obtaining licenses. Since then, five U.S. companies had obtained licenses (as of early December 2006), and MOFCOM generally remained slow in

processing a growing number of license applications from foreign and domestic companies. The United States, meanwhile, has continued to urge China to revise its direct selling measures and to process direct selling applications in a timely and transparent manner in order to facilitate legitimate commerce and to comply with its WTO commitments, both in bilateral meetings and at the November 2006 transitional review before the Council for Trade in Services. The United States will continue these efforts in 2007.

## **Import Regulation**

### ***Tariffs***

Through its bilateral negotiations with interested WTO members leading up to its accession, China agreed to greatly increase market access for U.S. and other foreign companies by reducing tariff rates. The agreed reductions are set forth as tariff “bindings” in China’s Goods Schedule, meaning that while China cannot exceed the bound tariff rates, it can decide to apply them at a lower rate, as many members do when trying to attract particular imports.

As in prior years, China implemented its scheduled tariff reductions for 2006 on schedule. These reductions, made on January 1 and July 1, involved principally motor vehicles and motor vehicle parts.

U.S. exports continued to benefit from China’s participation in the Information Technology Agreement (ITA), which requires the elimination of tariffs on computers, semiconductors and other information technology products. China began reducing and eliminating these tariffs in 2002 and continued to do so in the ensuing years, achieving the elimination of all ITA tariffs on January 1, 2005, as the tariffs dropped to zero from a pre-WTO accession average of 13.3 percent. U.S. exports of ITA goods continued to perform well in 2006, as they were projected to exceed \$6.8 billion by the end of the year, increasing by 68 percent from January through September 2006, when compared to the same time period in 2005.

China completed its timely implementation of another significant tariff initiative, the WTO’s Chemical Tariff Harmonization Agreement, in 2005. U.S. chemical exports covered by this agreement increased by eight percent from January through September 2006 and are on a pace to surpass the healthy total of \$5.8 billion in 2005.

Overall, China’s tariff changes have increased market access for U.S. exporters in a range of industries, as China continued the process of reducing tariffs on goods of greatest importance to U.S. industry from a base average of 25 percent (in 1997) to 7 percent over a period of five years, running from January 1, 2002, while it made similar reductions throughout the agricultural sector (see the Agriculture section below). These tariff changes contributed to another significant increase in overall U.S. exports, which rose approximately 35 percent from January through September 2006, when compared to the same time period in 2005.

### ***Customs and Trade Administration***

Like other acceding WTO members, China agreed to take on the WTO obligations that address the means by which customs and other trade administration officials check imports and establish and apply relevant trade regulations. These agreements cover the areas of customs valuation, rules of origin and import licensing.

### Customs Valuation

The WTO Agreement on the Implementation of GATT Article VII (Agreement on Customs Valuation) is designed to ensure that determinations of the customs value for the application of duty rates to imported goods are conducted in a neutral and uniform manner, precluding the use of arbitrary or fictitious customs values. Adherence to the Agreement on Customs Valuation is important for U.S. exporters, particularly to ensure that market access opportunities provided through tariff reductions are not negated by unwarranted and unreasonable “uplifts” in the customs value of goods to which tariffs are applied. China agreed to implement its obligations under the Agreement on Customs Valuation upon accession, without any transition period. In addition, China’s accession agreement reinforces China’s obligation not to use minimum or reference prices as a means for determining customs value. It also called on China to implement the *Decision on Valuation of Carrier Media Bearing Software for Data Processing Equipment* and the *Decision on Treatment of Interest Charges in Customs Value of Imported Goods* by December 11, 2003.

In January 2002, shortly after acceding to the WTO, China’s Customs Administration issued the *Measures for Examining and Determining Customs Valuation of Imported Goods*. These regulations addressed the inconsistencies that had existed between China’s customs valuation methodologies and the Agreement on Customs Valuation. The Customs Administration subsequently issued the *Rules on the Determination of Customs Value of Royalties and License Fees Related to Imported Goods*, effective July 2003. These rules were intended to clarify provisions of the January 2002 regulations that address the valuation of royalties and license fees. In addition, by December 11, 2003, China had issued a measure on interest charges and a measure requiring duties on software to be assessed on the basis of the value of the underlying carrier medium, meaning, for example, the CD-ROM or floppy disk itself, rather than based on the imputed value of the content, which includes, for example, the data recorded on a CD-ROM or floppy disk.

More than three years later, China has still not uniformly implemented these various measures. U.S. exporters continue to report that they are encountering valuation problems at many ports. According to U.S. exporters, even though the 2002 regulations and 2003 implementing rules provide that imported goods normally should be valued on the basis of their transaction price, meaning the price the importer actually paid, many Chinese customs officials are still improperly using “reference pricing,” which usually results in a higher dutiable value. For example, imports of wood products are often subjected to reference pricing. In addition, some of China’s customs officials are reportedly not applying the provisions in the 2002 regulations and 2003 implementing rules as they relate to software royalties and license fees. Following their pre-WTO accession practice, these officials are still automatically adding royalties and license fees to



the dutiable value (for example, when an imported personal computer includes pre-installed software), even though China's 2003 implementing rules expressly direct them to add those fees only if they are import-related and a condition of sale for the goods being valued.

U.S. exporters have also continued to express concerns about the Customs Administration's handling of imports of digital media that contain instructions for the subsequent production of multiple copies of products such as DVDs. The Customs Administration has been inappropriately assessing duties based on the estimated value of the yet-to-be-produced copies.

More generally, U.S. exporters continue to be concerned about inefficient and inconsistent customs clearance procedures in China. These procedures vary from port to port, massive delays are not uncommon, and the fees charged appear to be excessive and are rising rapidly, giving rise to concerns about China's compliance with its obligations under Article VIII of GATT 1994.

When the United States first presented its concerns about the customs valuation problems being encountered by U.S. companies, China indicated that it was working to establish more uniformity in its adherence to WTO customs valuation rules. Since then, the United States has sought to assist in this effort in part by conducting technical assistance programs for Chinese government officials on WTO compliance in the customs area. In addition, in 2006, as in prior years, the United States raised its concerns about particular customs valuation problems during the transitional review before the WTO's Committee on Customs Valuation.

### Rules of Origin

Upon its accession to the WTO, China became subject to the WTO Agreement on Rules of Origin, which sets forth rules designed to increase transparency, predictability and consistency in both the establishment and application of rules of origin, which are necessary for import and export purposes, such as determining the applicability of import quotas, determining entitlement to preferential or duty-free treatment and imposing antidumping or countervailing duties or safeguard measures, and for the purpose of confirming that marking requirements have been met. The Agreement on Rules of Origin also provides for a work program leading to the multilateral harmonization of rules of origin. This work program is ongoing, and China specifically agreed to adopt the internationally harmonized rules of origin once they were completed. China also confirmed that it would apply rules of origin equally for all purposes and that it would not use rules of origin as an instrument to pursue trade objectives either directly or indirectly.

In March 2001, shortly after China's accession to the WTO, the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ) issued regulations and implementing rules intended to bring the rules of origin used by China to check marking requirements into compliance with the Agreement on Rules of Origin. U.S. exporters have not raised concerns with China's implementation of these regulations.

Almost three years after China's WTO accession, in September 2004, China finally issued the *Regulations of the Place of Origin for Imported and Exported Goods*, the important regulations

intended to bring China's rules of origin into conformity with WTO rules for import and export purposes. These regulations supersede the *Interim Provisions on the Place of Origin for Imported Goods*, issued by the Customs Administration in 1986, and the *Rules on the Place of Origin for Exported Goods*, issued by the State Council in 1992. The Customs Administration subsequently issued implementing rules addressing the issue of substantial transformation – the *Rules on Substantial Transformation Criteria Under the Non-Preferential Rules of Origin* – in December 2004.

### Import Licensing

The Agreement on Import Licensing Procedures (Import Licensing Agreement) establishes rules for WTO members, like China, that use import licensing systems to regulate their trade. Its aim is to ensure that the procedures used by members in operating their import licensing systems do not, in themselves, form barriers to trade. The objective of the Import Licensing Agreement is to increase transparency and predictability and to create disciplines to protect the importer against unreasonable requirements or delays associated with the licensing regime. The Import Licensing Agreement covers both “automatic” licensing systems, which are intended only to monitor imports, not regulate them, and “non-automatic” licensing systems, which are normally used to administer tariff-rate quotas or import restrictions such as quotas or to administer safety or other requirements, e.g., for hazardous goods, armaments or antiquities. While the Import Licensing Agreement's provisions do not directly address the WTO consistency of the underlying measures that licensing systems regulate, they do establish the baseline of what constitutes a fair and non-discriminatory application of import licensing procedures. In addition, China specifically committed not to condition the issuance of import licenses on performance requirements of any kind, such as local content, export performance, offsets, technology transfer or research and development, or on whether competing domestic suppliers exist.

Shortly after China acceded to the WTO, MOFTEC issued regulations revising China's automatic import licensing regime, and it later supplemented these regulations with implementing rules. MOFTEC also issued regulations revising China's non-automatic licensing regime. Following their issuance, the United States raised various concerns with MOFCOM regarding the regulations on automatic and non-automatic licensing in an effort to promote clarity and to ensure that the licensing procedures do not have trade-distorting or restrictive effects. Together with other WTO members, including the EC and Japan, the United States also presented detailed comments on various aspects of these regulations at meetings of the WTO's Import Licensing Committee, including the transitional reviews, in 2002, 2003 and 2004.

In May 2005, after Chinese steel producers negotiated contracts with major foreign iron ore suppliers, the Chinese government began imposing new import licensing procedures for iron ore without prior WTO notification. Even though the WTO's Import Licensing Agreement calls for import licensing procedures that do not have a restrictive effect on trade, China reportedly restricted licenses to 48 traders and 70 steel producers and did not make public a list of the qualified enterprises or the qualifying criteria used. The United States and Australia sought to clarify the operation of the import licensing procedures applicable to iron ore during the

transitional reviews before the Committee on Import Licensing in October 2005 and the Council for Trade in Goods in November 2005. While China maintained that the Chinese government did not impose any qualifying criteria, it did acknowledge that two organizations affiliated with the Chinese government, the China Steel Industry Association and the Commercial Chamber for Metals, Minerals and Chemicals Importers and Exporters, had been discussing a set of rules regarding qualifying criteria such as production capacity and trade performance.

In 2006, the United States continued to monitor this situation, which could set a troubling precedent for the handling of imports of other raw materials. Because China seemed determined to restrict the availability of import licenses, the United States raised its concerns with China bilaterally in October 2006 during a meeting of the U.S.-China Steel Dialogue (Steel Dialogue), created earlier in the year under the auspices of the JCCT. The United States also addressed this issue during the transitional review before the Committee on Import Licensing, held in October 2006, as did Australia. The United States will continue these efforts in 2007.

The United States has also focused considerable attention on import licensing issues that have arisen in a variety of other specific contexts since China's WTO accession. In 2006, these include the administration of tariff-rate quota systems, sanitary and phytosanitary (SPS) measures and inspection-related requirements (discussed below in the sections on Tariff-rate Quotas on Industrial Goods, Tariff-rate Quotas on Bulk Agricultural Commodities, Sanitary and Phytosanitary Issues and Inspection-Related Requirements).

### *Non-tariff Measures*

In its accession agreement, China agreed that it would eliminate numerous trade-distortive non-tariff measures (NTMs), including import quotas, licenses and tendering requirements covering hundreds of products. Most of these NTMs, including, for example, the NTMs covering chemicals, agricultural equipment, medical and scientific equipment and civil aircraft, had to be eliminated by the time that China acceded to the WTO. China committed to phase out other NTMs, listed in an annex to the accession agreement, over a transition period ending on January 1, 2005. These other NTMs included import quotas on industrial goods such as air conditioners, sound and video recording apparatus, color TVs, cameras, watches, crane lorries and chassis, and motorcycles as well as licensing and tendering requirements applicable to a few types of industrial goods, such as machine tools and aerials.

As has been previously reported, China's import quota system was beset with problems. The State Council was late in issuing necessary regulations, and the authorities charged with implementing this system – MOFTEC for some products and the State Economic and Trade Commission (SETC) for others – were late in allocating quotas. Because of a lack of transparency, it was also difficult to assess whether the quotas were allocated in accordance with the agreed rules. Some of the more difficult problems were encountered with the auto import quota system, resulting at times in significant disruption of wholesale and retail operations for imported autos.

While these problems prevented the United States and other WTO members from realizing the full contemplated benefits of these import quotas, China did fully adhere to the agreed schedule for the elimination of all of its import quotas as well as all of its other NTMs, the last of which China eliminated in January 2005. In some cases, China even eliminated NTMs ahead of schedule, as it did with the import quotas on crane lorries and chassis, and motorcycles.

### ***Tariff-rate Quotas on Industrial Products***

In its WTO accession agreement, China agreed to implement a system of tariff-rate quotas (TRQs) designed to provide significant market access for three industrial products, including fertilizer, a major U.S. export. Under this TRQ system, a set quantity of imports is allowed at a low tariff rate, while imports above that level are subject to a higher tariff rate. In addition, the quantity of imports allowed at the low tariff rate increases annually by an agreed amount. China's accession agreement specifies detailed rules, requiring China to operate its fertilizer TRQ system in a transparent manner and dictating precisely how and when China is obligated to accept quota applications, allocate quotas and reallocate unused quotas.

As previously reported, SETC was slow to implement its TRQ system in 2002, and a lack of transparency made it difficult to assess whether the quota allocations followed the rules set out in China's goods schedule. U.S. exporters also expressed concern about the Chinese government's issuance of administrative guidance that discouraged some TRQ holders from freely utilizing their quotas. In July 2002, following repeated bilateral engagement, the United States requested formal consultations with China under the headnotes in China's goods schedule. During the ensuing consultations, which took place in September 2002 in Geneva, China was forthcoming in its responses and provided the United States with a better understanding of the challenges facing it, but the United States and China were unable to agree on concrete steps to remedy the situation.

In 2003, as the United States continued to engage China, SETC issued the quota allocations on time and apparently in the correct amount, representing a substantial improvement over 2002. However, U.S. companies continued to express concern about administrative guidance discouraging TRQ holders from freely utilizing their quotas. According to reports from these companies, administrative guidance may have been used to limit imports of the principal U.S. fertilizer product, diammonium phosphate (DAP), to less than 60 percent of the quota allocations actually issued by SETC. U.S. fertilizer exports to China declined by 32 percent in 2003, totaling \$459 million as compared to \$676 million in 2002.

Even after SETC was merged into MOFCOM as part of the mid-2003 government restructuring, the systemic problems did not go away. Despite continued U.S. engagement, principally through the transitional review before the WTO's Committee on Market Access, China's fertilizer TRQ system was still operating with insufficient transparency in 2004, and administrative guidance still seemed to be affecting how allocated quota was used. U.S. fertilizer exports to China were down 33 percent in 2004 relative to 2003, totaling \$306 million, due in part to the continuing

problems with MOFCOM's administration of the fertilizer TRQ system and in part to increasing subsidization – and resulting overcapacity – of China's domestic fertilizer industry.

In 2005 and 2006, MOFCOM's administration of the fertilizer TRQ system did not noticeably improve, and the United States again raised concerns about how this system was being administered during the annual transitional reviews before the Committee on Market Access. U.S. fertilizer exports to China, meanwhile, increased modestly in 2005, totaling \$355 million for the year, but then declined sharply in 2006. The data for January through September 2006 showed a decline of 32 percent, totaling \$151 million as compared to \$223 million during the same period in 2005.

In October 2006, perhaps in an attempt by the central authorities to reign in provincial and local efforts to build further unneeded capacity, the Tariff Policy Commission of the State Council announced a temporary reduction of the in-quota tariff rate for fertilizer from four percent to one percent, effective November 2006. It is too early to tell what effect this change may have on U.S. fertilizer exports to China. However, U.S. and other foreign fertilizer producers are anticipating increased exports after December 11, 2006, when China is scheduled to begin allowing foreign enterprises to engage in the wholesale and retail distribution of fertilizer within China. The United States will monitor developments in this area closely in 2007.

### ***Other Import Regulation***

#### Antidumping

In its WTO accession agreement, China committed to revising its regulations and procedures for antidumping (AD) proceedings by the time of its accession, in order to make them consistent with the WTO Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (AD Agreement). That agreement sets forth detailed rules prescribing the manner and basis on which a WTO member may take action to offset the injurious dumping of products imported from another WTO member. China also agreed to provide for judicial review of determinations made in its AD investigations and reviews.

China has become a leading user of AD measures since its accession to the WTO. Currently, China has in place a total of 86 final AD measures affecting imports from 18 countries, with 25 AD investigations in progress. According to U.S. AD experts, the greatest shortcomings in China's AD practice continue to be in the areas of transparency and procedural fairness. The United States continues to press China both bilaterally and multilaterally to clarify and address these concerns.

Five years have passed since China's WTO accession, and much of the legal framework for its AD regime appears to be in place, although key pieces of legislation have not yet been notified to the WTO. Shortly before China's accession to the WTO, the State Council issued new AD regulations that went into effect in January 2002 and charged MOFTEC with making determinations of dumping. In early 2002, MOFTEC issued several sets of provisional rules

covering initiation of investigations, questionnaires, sampling, verifications, information disclosure, access to non-confidential information, price undertakings, hearings, interim reviews, refunds and new shipper reviews. SETC, which at the time was charged with making determinations of injury, issued rules covering industry injury investigations and public hearings in January 2003. These regulations were updated and notified to the WTO's AD Committee following the consolidation of the AD functions of MOFTEC and SETC into the newly formed MOFCOM in March 2003. A revised version of China's governing statute, the Foreign Trade Law, which included expanded trade remedy language, came into force in July 2004 and was also eventually notified to the AD Committee. More recently, in August 2006, MOFCOM issued the Regulations on Information Accession and Information Disclosure in Industry Injury Investigations, but this measure has not yet been notified to the AD Committee.

China has also issued rules governing judicial review of AD cases. In August 2002, the Supreme People's Court issued the Rules Regarding Supreme People's Court Hearings on Judicial Review of International Trade Disputes, which provide guidance concerning judicial review of administrative agency decisions affecting international trade, including disputes involving AD cases. In September 2002, the Supreme People's Court issued the Provisions of the Supreme People's Court on Certain Issues Concerning the Applicability of Laws in the Hearing and Handling of Antidumping Administrative Cases. As China continues to launch AD investigations and apply AD measures against imports, the opportunity for interested parties to seek judicial review will become more critical. To date, however, neither of these measures has been notified to the AD Committee, preventing effective multilateral review of critical elements of China's judicial review mechanism.

Within MOFCOM, the Bureau of Fair Trade for Imports and Exports (BOFT) is charged with making dumping determinations and the Bureau of Industry Injury Investigation (IBII) is charged with making injury determinations. The State Council Tariff Commission continues to make the final decision on imposing, revoking or retaining AD duties, based on recommendations provided by the BOFT and the IBII, although its authority relative to MOFCOM has not been clearly defined in the regulations and rules since MOFCOM was established.

In practice, China's conduct of AD investigations has not fully observed the fundamental tenets of transparency and procedural fairness embodied in the AD Agreement. For example, respondents from the United States and other WTO members that have been subject to Chinese AD investigations continue to express concerns about the lack of detailed information made available to interested parties. While the BOFT has improved somewhat at making documents from AD investigations reasonably available on demand, the IBII continues to have an uneven record with respect to making available to foreign respondents materials generated and submitted during the course of its injury investigations. In addition, both BOFT and IBII still fail to make available adequate non-confidential summaries of submissions by Chinese producers, precluding interested parties from gaining a full understanding of potentially important facts and data in the record of an investigation. Compounding this problem is the highly limited disclosure by China's AD authorities of the essential facts underlying decisions and calculations made in the course of dumping and injury investigations.

Meanwhile, foreign respondents continue to criticize China's AD authorities for not providing adequate opportunities for interested parties to provide input for their deliberations, particularly with regard to the IBII's injury determinations. At least one positive development took place in 2006, however, when the IBII held a public hearing at an early stage of an AD investigation, allowing foreign respondents the opportunity to place arguments on the record well in advance of the IBII's preliminary injury determination. Foreign respondents also continue to criticize the cursory nature of decision making in the IBII's injury investigations, including the analysis regarding the causal link between injury and dumping. Indeed, in the many investigations initiated by MOFCOM since China's WTO accession, the IBII has not once found that U.S. exports were not causing injury to China's domestic industry, despite compelling arguments raised by U.S. respondents.

At the WTO, the United States continues to address problems with China's AD practice in regular meetings of the AD Committee. The United States also continues to make vigorous use of the transitional review mechanism to clarify issues and voice concerns regarding China's AD practices. During the most recent transitional review before the AD Committee in October 2006, the United States and other WTO members, including the EC and Japan, reiterated their longstanding concerns regarding transparency and procedural fairness.

The United States also vigorously engages China bilaterally on these matters. In April 2004, the United States and China agreed to establish the Trade Remedies Working Group under the auspices of the JCCT. This working group has given U.S. AD experts a dedicated forum to engage Chinese administrators and decision-makers directly and in detail regarding the problems facing U.S. exporters subject to Chinese AD investigations. U.S. AD officials also have frequent formal and informal exchanges with China's AD authorities, which help to promote greater transparency and accountability in China's AD regime. At the same time, the United States continues to work closely with U.S. companies affected by Chinese AD investigations in an effort to help them better understand the Chinese system. The United States also advocates on their behalf in connection with ongoing AD investigations, with the goal of obtaining fair and objective treatment for them, consistent with the AD Agreement.

In the antidumping investigation of unbleached kraft linerboard (a cardboard-like packaging material) that MOFCOM initiated in March 2004, U.S. respondents raised a variety of substantive and procedural issues, with one of their principal arguments being that Chinese producers had not suffered any material injury. The United States actively supported many of the positions taken by the U.S. respondents, particularly with regard to the injury issue, which raised WTO concerns. Nevertheless, in September 2005, MOFCOM issued its final determination, finding both dumping and injury, and began imposing antidumping duties on imports of U.S. kraft linerboard. Working closely with U.S. industry, the United States pressed MOFCOM to reverse its injury finding and withdraw the antidumping duties, but these efforts were rebuffed. In early January 2006, the United States notified China as a courtesy that it would be filing a request for WTO consultations the following week. Over the weekend, MOFCOM issued an "administrative reconsideration" in which it rescinded the antidumping duties on kraft linerboard imports.

### Countervailing Duties

In its WTO accession agreement, China committed to revising its regulations and procedures for conducting countervailing duty (CVD) investigations and reviews by the time of its accession, in order to make them consistent with the WTO Agreement on Subsidies and Countervailing Measures (Subsidies Agreement). The Subsidies Agreement sets forth detailed rules prescribing the manner and basis on which a WTO member may take action to offset the injurious subsidization of products imported from another WTO member. Although China did not separately commit to provide judicial review of determinations made in CVD investigations and reviews, Subsidies Agreement rules require independent review.

As previously reported, shortly before China's accession, the State Council issued new CVD regulations, which came into force in January 2002. Later, MOFTEC, which at that time was charged with making determinations of subsidization under China's CVD regime, issued several sets of ministerial rules on initiation of investigations, questionnaires, verifications and hearings. The SETC, which at that time was charged with making determinations of injury in China's CVD proceedings, issued implementing rules covering industry injury investigations and public hearings in January 2003. In March 2003, a general reorganization of the State Council ministries and commissions consolidated the subsidization and injury investigation functions of MOFTEC and SETC into MOFCOM. Updated regulations were later notified to the WTO, as was the revised *Foreign Trade Law*, as discussed above in the Antidumping section.

As in the AD area, China continues in its efforts to conform its CVD regulations and procedural rules to the provisions and requirements of the Subsidies Agreement and the commitments in its WTO accession agreement. China's regulations and procedural rules generally track those found in the Subsidies Agreement, although there are certain areas where key provisions are omitted or are vaguely worded. Since China's accession to the WTO, the United States and other WTO members have sought clarifications on a variety of issues concerning China's regulatory framework and have pressed China for greater transparency both during regular meetings and the annual transitional reviews before the Subsidies Committee. The United States will continue to seek clarifications as needed in 2007.

China has not initiated a CVD investigation, either pre- or post-WTO accession. Consequently, it is not yet possible to assess whether China applies its regulations and procedural rules in conformity with WTO rules.

### Safeguards

In its WTO accession agreement, China committed to revising its regulations and procedures for conducting safeguard investigations by the time of its WTO accession in order to make them consistent with the WTO Agreement on Safeguards (Safeguards Agreement). That agreement articulates rules and procedures governing WTO members' use of safeguard measures.



As previously reported, shortly before China's WTO accession, the State Council issued the *Regulations on Safeguards*, which became effective in January 2002. Under these regulations, MOFTEC became responsible for determining whether the volume of imports of a given product has increased and (together with SETC) whether there is a causal link between any such imports and injury to the domestic industry. Shortly thereafter, MOFTEC issued two sets of provisional procedural rules, one covering initiations and the other hearings. In 2003, SETC, the agency that was charged with determining injury to the domestic industry, issued the *Rules on Investigations and Determinations of Industry Injury for Safeguards* and the *Rules on Public Hearings with Regard to Investigations of Injury to Industry*. Later that year, a general reorganization of the State Council ministries and commissions consolidated the safeguard functions of MOFTEC and SETC into MOFCOM. In 2004, the State Council issued revised *Regulations on Safeguards*, and MOFCOM issued revised implementing rules to reflect this change.

As with the AD and CVD areas, it appears that China has made an effort to establish a WTO-consistent safeguard regime. While the provisions of China's regulations and procedural rules generally track those of the Safeguards Agreement, there are some potential inconsistencies, and certain omissions and ambiguities remain. In addition, some provisions do not find a counterpart in the Safeguards Agreement. In earlier transitional reviews before the WTO's Committee on Safeguards, the United States noted several areas of potential concern, including transparency, determination of developing country status, treatment of non-WTO members, protection of confidential data, access to non-confidential information, refunding of safeguard duties collected pursuant to provisional measures when definitive measures are not imposed, and the conditions governing the extension of a safeguard measure.

To date, China has conducted only one safeguard proceeding. In May 2002, MOFTEC initiated an investigation addressing imports of certain steel products from various countries, including the United States. China imposed provisional measures in the form of tariff-rate quotas on nine categories of products the day after initiation, and six months later it rendered a final determination maintaining these measures in place. Although U.S. companies exported little of the subject merchandise to China, there were complaints from interested parties that China's process for allocating quotas under the safeguard measures was unclear, making it difficult for them to determine the quota available and obtain a fair share. MOFCOM terminated the safeguard measures in December 2003.

### **Export Regulation**

China's WTO accession agreement reinforces China's obligation to only maintain export restrictions allowed under WTO rules. In this regard, Article XI of the GATT 1994 generally prohibits WTO members from maintaining export restrictions (other than duties, taxes or other charges), although certain limited exceptions are allowed. China also agreed to eliminate all taxes and charges on exports, except as included in Annex 6 to the Protocol of Accession or applied in conformity with Article VIII of GATT 1994. Article VIII of GATT 1994 only permits fees and charges limited to the approximate cost of services rendered and makes clear that any

such fees and charges shall not represent an indirect protection to domestic products or a taxation of exports for fiscal purposes.

Nevertheless, since its accession to the WTO, China has continued to impose restrictions on exports of certain raw materials and intermediate products. In an attempt to justify these restrictions, MOFCOM has often cited Article XX(g) of GATT 1994, which permits a WTO member to impose measures relating to the conservation of exhaustible natural resources, provided that such measures are made effective in conjunction with restrictions on domestic production or consumption, and provided they are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail or a disguised restriction on international trade.

In 2004, China's longstanding export restrictions on blast furnace coke, a key steel input, began to have a significant, adverse effect on U.S. integrated steel producers and their customers. China was (and is) the world's largest producer of coke as well as the world's most significant exporter of coke, supplying more than one-half of the world's traded coke. Even though its total production was projected to (and did) rise to nearly 210 million metric tons (MT) in 2004, China initially imposed an export quota of 8.3 million MT, down from the 2003 level of 14.3 million MT. In the first six months of 2004, China's export quota, combined with the illegal sale of export quota certificates, caused the export price for Chinese coke to rise to the vicinity of \$500 per MT, more than three times the price in 2003. This price rise triggered a similar rise in world coke prices, while Chinese domestic prices ranged between \$150 and \$200 per MT, giving Chinese steel producers a significant competitive advantage over their foreign competitors and helping to fuel the rapid expansion of China's steel sector.

The United States began to raise its concerns with China's coke export restrictions during high-level meetings in Washington in April 2004. The United States urged China to put the practice of using export restrictions behind it, not just for coke but also for other products. The United States also began to coordinate with other concerned WTO members, particularly the EC and Japan, which had become active in addressing this issue. In late July 2004, following sustained engagement by the United States, which included both high-level contacts and a series of meetings with MOFCOM officials in Beijing, the Chinese government raised the 2004 quota allotment to 12.3 million MT and indicated that it would eventually be raising the quota to the 2003 level of 14.3 million MT. Shortly thereafter, MOFCOM also issued an urgent notice reiterating that the sale of export licenses was illegal and called for investigations and expedited reports on this practice by provincial MOFCOM authorities. In the ensuing months, with the increased supply of Chinese coke and the crackdown on the sale of export licenses, the export prices for Chinese coke declined significantly, reaching nearly \$200 per MT. U.S. industry was also able to obtain a substantially larger quantity of Chinese coke in 2004 than it had in 2003.

In 2005, the United States continued to press China for complete elimination of the annual export quota on coke, as did other WTO members. The United States raised its concerns in bilateral meetings with China and at the WTO during the transitional reviews before the Committee on Market Access and the Council for Trade in Goods, but made no progress.

In 2006, the United States continued to press China to eliminate the export quota on coke, both bilaterally during Steel Dialogue meetings in March and October and at the transitional reviews before the Committee on Market Access and the Council for Trade in Goods, held in October and November. Even though the export price for Chinese coke remained relatively low compared to the \$500 per MT price of mid-2004, the export quota still kept world coke prices artificially high in 2006, and a significant differential still existed between China's domestic coke prices and world coke prices. However, the Chinese government continued its efforts to direct market outcomes by maintaining the export quota on coke. Indeed, in October 2006, China took the additional step of imposing a five percent duty on exports of coke.

Fluorspar is another example of a raw material subject to export restrictions, as China imposes both quotas and license fees on fluorspar exports. The objective of these export restrictions appears to be to support China's downstream producers of the numerous products derived from fluorspar, such as non-ozone depleting hydrofluorocarbon refrigerants and foam blowing agents. While their foreign competitors pay higher world market prices for fluorspar, China's downstream producers benefit from the artificially low domestic prices for fluorspar and are able to export their products around the world at prices well below those of their foreign competitors.

Since shortly after China's WTO accession, the United States has raised its concerns about the export restrictions on fluorspar bilaterally with China. The United States has also worked with other WTO members with an interest in this issue, including Japan, and raised this issue during the annual transitional reviews before the Committee on Market Access and the Council for Trade in Goods. To date, however, China has refused to modify its practices in this area. In fact, China has increased the protection afforded to its downstream producers by lowering the export quota on fluorspar each year and, in October 2006, by imposing a 10 percent duty on exports of fluorspar.

In 2007, the United States will continue to work with interested trading partners on these issues. In coordination with those trading partners, the United States will urge China to act as a responsible stakeholder in the international trading system and eliminate the export restrictions that it maintains on raw materials such as coke and fluorspar.

## **Internal Policies Affecting Trade**

### ***Non-discrimination***

In its WTO accession agreement, China agreed to assume the obligations of GATT 1994, the WTO agreement that establishes the core principles that constrain and guide WTO members' policies relating to trade in goods. The two most fundamental of these core principles are the Most-Favored Nation (MFN), or non-discrimination, rule – referred to in the United States as “normal trade relations” – and the rule of national treatment.

The MFN rule (set forth in Article I of GATT 1994) attempts to put the goods of all of an importing WTO member's trading partners on equal terms with one another by requiring the

same treatment to be applied to goods of any origin. It generally provides that if a WTO member grants another country's goods a benefit or advantage, it must immediately and unconditionally grant the same treatment to imported goods from all WTO members. This rule applies to customs duties and charges of any kind connected with importing and exporting. It also applies to internal taxes and charges, among other internal measures.

The national treatment rule (set forth in Article III of GATT 1994) complements the MFN rule. It attempts to put the goods of an importing WTO member's trading partners on equal terms with the importing member's own goods by requiring, among other things, that a WTO member accord no less favorable treatment to imported goods than it does for like domestic goods. Generally, once imported goods have passed across the national border and import duties have been paid, the importing WTO member may not subject those goods to internal taxes or charges in excess of those applied to domestic goods. Similarly, with regard to measures affecting the internal sale, purchase, transportation, distribution or use of goods, the importing WTO member may not treat imported goods less favorably than domestic goods.

In its WTO accession agreement, China agreed to repeal or revise all laws, regulations and other measures that were inconsistent with the MFN rule upon accession. China also confirmed that it would observe this rule with regard to all WTO members, including separate customs territories, such as Hong Kong, Macau and Taiwan. In addition, China undertook to observe this rule when providing preferential arrangements to foreign-invested enterprises within special economic areas.

With regard to the national treatment rule, China similarly agreed to repeal or revise all inconsistent laws, regulations and other measures. China also specifically acknowledged that its national treatment obligation extended to the price and availability of goods or services supplied by government authorities or state-owned enterprises, as well as to the provision of inputs and services necessary for the production, marketing or sale of finished products. Among other things, this latter commitment precludes dual pricing, i.e., the practice of charging foreign or foreign-invested enterprises more for inputs and related services than Chinese enterprises. China also agreed to ensure national treatment in respect of certain specified goods and services that had traditionally received discriminatory treatment in China, such as boilers and pressure vessels (upon accession), after sales service (upon accession), and pharmaceuticals, chemicals and spirits (one year after accession).

As previously reported, China reviewed its pre-WTO accession laws and regulations and revised many of those which conflicted with its WTO MFN and national treatment obligations in 2002. Most of these revisions were made to secure national treatment, including with regard to boilers and pressure vessels, after sales service, and the pricing of pharmaceutical products, among other areas. In 2003, China made further revisions covering registration requirements for foreign chemical products and the regulation of spirits.

China also undertook a major restructuring of its trade and investment-related ministries in mid-2003, following significant changes in the leadership of China's Communist Party and the

national government. One principal component of this restructuring was combining domestic and foreign trade-related functions into one agency (as SETC and parts of the State Development and Planning Commission, or SDPC, were folded into MOFTEC, which became known as the Ministry of Commerce, or MOFCOM), in part to foster better adherence to the WTO's national treatment principle. In addition, NDRC, the successor to SDPC, has become much more open to discussing the policy concerns of foreign businesses, which contrasts sharply with its prior reputation.

However, China still does not appear to observe MFN and national treatment requirements in all areas. For example, several U.S. industries reported that China continued to apply the value-added tax in a manner that unfairly discriminates between imported and domestic goods, both through official measures and on an *ad hoc* basis, as discussed below in the Taxation section. It also appears that China has applied sanitary and phytosanitary measures in a discriminatory manner continually since it acceded to the WTO, as discussed below in the Agriculture section. In addition, China's industrial policies on automobiles and steel appear to discriminate against foreign producers as well as imported goods, as discussed below in the Investment section.

The United States continued to address these and other MFN and national treatment issues with China in 2006, both bilaterally and in WTO meetings, such as the transitional reviews before the Committee on Market Access, the Committee on Trade-Related Investment Measures (TRIMS Committee), the Committee on Sanitary and Phytosanitary Measures (SPS Committee), the Council for Trade in Goods, the Committee on Trade in Financial Services and the Council for Trade in Services. The United States will continue to pursue these issues vigorously in 2007.

## **Taxation**

China committed to ensure that its laws and regulations relating to taxes and charges levied on imports and exports would be in full conformity with WTO rules upon accession, including, in particular, the MFN and national treatment provisions of Articles I and III of GATT 1994.

### Value-Added Tax Policies

Since China's WTO accession, certain aspects of China's VAT system have raised serious national treatment concerns. One of these issues – the discriminatory tax rates applied to imports versus domestically produced semiconductors – was resolved in 2004, although other issues remain.

As previously reported, in an effort to develop its domestic integrated circuit (IC) industry, China began announcing discriminatory VAT policies in late 2001, although they did not become operational until 2004. Pursuant to a series of measures, China provided for the rebate of a substantial portion of the 17 percent VAT paid by domestic manufacturers on their locally produced ICs. A similar VAT rebate was available to imported ICs, but only if they had been designed in China. China charged the full 17 percent VAT on all other imported ICs. These policies disadvantaged U.S. exports of ICs to China, which totaled approximately \$2 billion in 2003, and put pressure on foreign enterprises to shift investment in IC manufacturing to China. Following extensive but unsuccessful bilateral engagement, the United States initiated dispute settlement by requesting formal WTO consultations with China in March 2004. In the ensuing consultations, which took place in April 2004 in Geneva, with third party participation by Japan, the EC and Mexico, the United States laid out its claims under Article III of GATT 1994, which sets forth the WTO's national treatment principle. Through these consultations and a series of bilateral meetings in Washington and Beijing, a settlement was reached in July 2004, pursuant to which China agreed to withdraw the challenged measures.

China has also used VAT policies to benefit domestic fertilizer production. In July 2001, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued a circular exempting all phosphate fertilizers except DAP from a 13 percent VAT. DAP, a product that the United States exports to China, competes with similar phosphate fertilizers produced in China, particularly monoammonium phosphate. The circular also allowed a partial VAT rebate for domestic producers of urea, a nitrogen fertilizer, through the end of 2002. The United States raised this issue bilaterally with China soon after it acceded to the WTO and in many subsequent bilateral meetings, including high-level meetings. The United States has also raised this issue at the WTO, both in regular meetings of the Committee on Market Access and during the annual transitional reviews, including in 2006. So far, however, China has refused to make any changes, although it did allow the special tax treatment for domestic urea to expire at the end of 2002. The United States will continue to press its concerns regarding this issue in 2007.

Meanwhile, several U.S. industries have continued to express concerns more generally about the unfair operation of China's VAT system. Often, Chinese producers are able to avoid payment of

the VAT on their products, either as a result of poor collection procedures, special deals or even fraud, while the full VAT still must be paid on competing imports. In discussions with Chinese government officials on this issue, the United States has raised its serious concerns about the discriminatory treatment effectively accorded to foreign products. The United States has also emphasized the value to China of a properly functioning VAT system as a revenue source.

Finally, China's border trade policy continues to generate MFN and other concerns. China provides preferential import duty and VAT treatment to certain products, often from Russia, apparently even when those products are not confined to frontier traffic as envisioned by Article XXIV of GATT 1994. In June 2003, China began to address these concerns when it eliminated preferential treatment for boric acid and 19 other products. However, several other products continue to benefit from preferential treatment. During the transitional reviews before the WTO's Council for Trade in Goods, including most recently in November 2006, the United States has continued to urge China to eliminate the preferential treatment for these remaining products.

### Consumption Taxes

National treatment concerns also continue to arise in connection with China's consumption tax regulations, which first went into effect in 1993 and apply to a range of consumer products, including spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles. Under these regulations, China uses different tax bases to compute consumption taxes for domestic and imported products, with the apparent result that the effective consumption tax rate for imported products is substantially higher than for domestic products. Since China's accession to the WTO, the United States has raised this issue with China, both bilaterally and during the annual transitional reviews conducted by the WTO Committee on Market Access and the Council for Trade in Goods. To date, China has not revised these regulations. The United States will continue to pursue appropriate revisions of these regulations in 2007.

### *Subsidies*

Upon its accession to the WTO, China agreed to assume the obligations of the WTO Subsidies Agreement, which addresses not only the use of CVD measures by individual WTO members (see the section above on Import Regulation, under the heading of Countervailing Duties), but also a government's use of subsidies and the application of remedies through enforcement proceedings at the WTO. As part of its accession agreement, China committed that it would eliminate, by the time of its accession, all subsidies prohibited under Article 3 of the Subsidies Agreement, i.e., subsidies contingent on export performance (export subsidies) and subsidies contingent on the use of domestic over imported goods (import substitution subsidies). This commitment expressly extended throughout China's customs territory, including in special economic zones and other special economic areas.

China also agreed to various special rules that apply when other WTO members seek to enforce the disciplines of the Subsidies Agreement against Chinese subsidies (either in individual WTO members' CVD proceedings or in WTO enforcement proceedings). Under these rules, in certain circumstances, WTO members can identify and measure Chinese subsidies using alternative methods in order to account for the special characteristics of China's economy. For example, in certain circumstances, when determining whether preferential government benefits have been provided to a Chinese enterprise via, e.g., a loan, WTO members can use foreign or other market-based criteria rather than Chinese benchmarks to ascertain the benefit of that loan and its terms. Special rules also govern the actionability of subsidies provided to state-owned enterprises.

Following increasing pressure from the United States and other WTO members, China finally submitted its long-overdue subsidies notification to the WTO's Subsidies Committee in April 2006. Although the notification is lengthy, with over 70 subsidy programs reported, it is also notably incomplete, as it failed to notify any subsidies provided by China's state-owned banks or by provincial and local government authorities. In addition, while China notified several subsidies that appear to be prohibited, it did so without making any commitment to withdraw them, and it failed to notify other subsidies that appear to be prohibited. The United States has devoted significant time and resources to monitoring and analyzing China's subsidy practices, and these efforts helped to identify significant omissions in China's subsidy notification. In accordance with Subsidies Committee procedures, the United States submitted extensive written questions and comments on China's subsidies notification in July 2006, as did several other WTO Members, including the EC, Japan, Canada, Mexico, Australia and Turkey. China has not yet responded to those submissions. During the annual transitional review before the Subsidies Committee, held in October 2006, the United States reiterated its concerns about China's subsidies notifications and urged China to withdraw its prohibited subsidies immediately.

A number of U.S. industries, including the steel, paper and textiles industries, among others, expressed increasing concern in 2006 about the injurious effects of China's subsidies in the U.S. market as well as in China and third-country markets. In addition, in October 2006, the U.S. paper industry filed a petition with the Commerce Department requesting the initiation of a CVD investigation based on allegations of subsidized imports of coated free sheet paper from China causing injury in the U.S. market. The petition acknowledges that the Commerce Department currently does not apply U.S. CVD law to China, but requests a change in that policy. In November 2006, the Commerce Department initiated an investigation, noting that it would decide on the applicability of U.S. CVD law to China during the course of its investigation.

The United States began seeking changes to China's subsidies practices immediately after China submitted its subsidies notification in April 2006. Through a series of bilateral meetings in Beijing, including high-level meetings, the United States made clear that China needed to withdraw both the prohibited subsidies that it had notified and several additional prohibited subsidies that it had not notified. The subsidies at issue benefit a wide range of industries in China and include both export subsidies, which make it more difficult for U.S. manufacturers to compete against Chinese manufacturers in the U.S. market and third-country markets, and import



substitution subsidies, which make it more difficult for U.S. manufacturers to export their products to China. To date, although the negotiations have made some progress, China has been unwilling to commit to the immediate withdrawal of the subsidies in question. The United States is continuing to press China on this issue and will take further actions seeking the withdrawal of these subsidies, including the initiation of WTO dispute settlement if appropriate.

In 2007, the United States will also continue to pursue its own research and analysis of possible Chinese subsidy programs. It will also continue to raise its concerns at the WTO and in bilateral meetings with China, as necessary, including through future meetings of the Structural Issues Working Group, which was created at the April 2004 JCCT meeting.

### ***Price Controls***

In its WTO accession agreement, China agreed that it would not use price controls to restrict the level of imports of goods or services. In addition, in an annex to the agreement, China listed the limited number of products and services remaining subject to price control or government guidance pricing, and it provided detailed information on the procedures used for establishing prices. China agreed that it would try to reduce the number of products and services on this list and that it would not add any products or services to the list, except in extraordinary circumstances.

In 2006, China continued to maintain price controls on several products and services provided by both state-owned enterprises and private enterprises. Published through the China Economic Herald and NDRC's website, these price controls may be in the form of either absolute mandated prices or specific pricing policy guidelines as directed by the government. Products and services subject to government-set prices include pharmaceuticals, tobacco, natural gas and certain telecommunications services. Products and services subject to government guidance prices include gasoline, kerosene, diesel fuel, fertilizer, cotton, various grains, various forms of transportation services, professional services such as engineering and architectural services, and certain telecommunications services.

The United States obtained additional information about China's use of price controls from the WTO Secretariat's Trade Policy Review report on China, issued in February 2006. The United States also sought clarifications from China in connection with China's Trade Policy Review, which took place in April 2006. In addition, as in prior years, the United States sought updated information from China on its use of price controls and future plans during the transitional review before the Subsidies Committee, held in October 2006. The United States will continue to monitor China's progress in eliminating price controls in 2007, and it will also work closely with U.S. industry in engaging China as it considers proposals for the imposition of price controls for medical devices.

### ***Standards, Technical Regulations and Conformity Assessment Procedures***

With its accession to the WTO, China assumed obligations under the Agreement on Technical Barriers to Trade (TBT Agreement), which establishes rules and procedures regarding the development, adoption and application of voluntary product standards, mandatory technical regulations, and the procedures (such as testing or certification) used to determine whether a particular product meets such standards or regulations. Its aim is to prevent the use of technical requirements as unnecessary barriers to trade. The TBT Agreement applies to a broad range of industrial and agricultural products. It establishes rules that help to distinguish legitimate standards and technical regulations from protectionist measures. Among other things, standards, technical regulations and conformity assessment procedures are to be developed and applied transparently and on a non-discriminatory basis and should be based on relevant international standards and guidelines, when appropriate.

In its WTO accession agreement, China also specifically committed that it would ensure that its conformity assessment bodies operate with transparency, apply the same technical regulations, standards and conformity assessment procedures to both imported and domestic goods and use the same fees, processing periods and complaint procedures for both imported and domestic goods. In addition, China agreed to ensure that all of its conformity assessment bodies are authorized to handle both imported and domestic goods within one year of accession. China also consented to accept the Code of Good Practice (set forth in an annex to the TBT Agreement) within four months after accession, which it has done, and to speed up its process of reviewing existing technical regulations, standards and conformity assessment procedures and harmonizing them with international norms.

In addition, in the Services Schedule accompanying its WTO accession agreement, China committed to permit foreign service suppliers that have been engaged in inspection services in their home countries for more than three years to establish minority foreign-owned joint venture technical testing, analysis and freight inspection companies upon China's accession to the WTO, with majority foreign ownership no later than two years after accession and wholly foreign-owned subsidiaries four years after accession. China further agreed that qualifying joint venture and wholly foreign-owned enterprises would be eligible for accreditation in China and accorded national treatment.

#### Restructuring of Regulators

As previously reported, in anticipation of its WTO accession, China made significant progress in the areas of standards and technical regulations. China addressed problems that foreign companies had encountered in locating relevant regulations and how they would be implemented, and it took steps to overcome poor coordination among the numerous regulators in China. In October 2001, China announced the creation of the Standardization Administration of China (SAC) under AQSIQ. SAC is charged with unifying China's administration of product standards and aligning its standards and technical regulations with international practices and China's commitments under the TBT Agreement. SAC is the Chinese member of the International Organization for Standardization and the International Electro-technical Commission.

China also began to take steps in 2001 to address problems associated with its multiplicity of conformity assessment bodies, whose task it is to determine if standards and technical regulations are being observed. AQSIQ was established as a new ministry-level agency in April 2001. It is the result of a merger of the State Administration for Quality and Technical Supervision and the State Administration for Entry-Exit Inspection and Quarantine. China's officials explained that this merger was designed to eliminate discriminatory treatment of imports and requirements for multiple testing simply because a product was imported rather than domestically produced. China also formed the quasi-independent National Certification and Accreditation Administration (CNCA), which is attached to AQSIQ and is charged with the task of unifying the country's conformity assessment regime.

Despite these changes, U.S. industry still has concerns about significant conformity assessment and testing-related issues in China. For example, U.S. exporters representing several sectors have reported that China's regulatory requirements are not enforced as strictly or uniformly against domestic producers as opposed to foreign producers. In addition, in some cases, China's regulations provide only that products will be inspected or tested upon entry into China's customs territory, without any indication as to whether or how the regulations will be applied to domestic producers.

### Transparency

In the area of transparency, AQSIQ's TBT inquiry point, established shortly after China acceded to the WTO, has continued to be helpful to U.S. companies as they try to navigate China's system of standards, technical regulations and conformity assessment procedures. In addition, China's designated notification authority, MOFCOM, has been notifying proposed technical regulations and conformity assessment procedures to WTO members, as required by the TBT Agreement. However, in 2006, as in prior years, almost all of the notified measures have emanated from AQSIQ or SAC and have rarely included measures from other agencies that appear to require notification, such as the Ministry of Health, the Ministry of Information Industry (MII), the State Environmental Protection Administration (SEPA) and the State Food and Drug Administration. Three years ago, in part to address this problem, China had reportedly formed a new inter-agency committee, with representatives from approximately 20 ministries and agencies and chaired by AQSIQ, to achieve better coordination on TBT (and sanitary and phytosanitary) matters, but progress has been inconsistent in this area.

As a result, some of China's TBT measures continue to enter into force without having first been notified to the TBT Committee, and without foreign companies having had the opportunity to comment on them or even being given a transition period during which to make necessary adjustments. One significant example from 2006 is SEPA's *Registration of Initial Imports of Chemical Products and System for Environmental Management of Imported and Exported Toxic Chemicals*, which entered into force in January.

Meanwhile, as the United States has consistently highlighted during regular meetings and the annual transitional reviews before the TBT Committee, the comment periods established by

China for the TBT measures actually notified continue to be unacceptably brief in some cases. In other cases, some U.S. companies reported that even when sufficient time was provided, written comments submitted by U.S. and other foreign interested parties seemed to be wholly disregarded. In still other cases, insufficient time was provided for Chinese regulatory authorities to consider interested parties' comments before a regulation was adopted.

One significant example of the transparency problems encountered by U.S. and other foreign industries is provided by MII's efforts to adopt the *Administrative Measures for Controlling Pollution Caused by Electronic Information Products*. This regulation, issued earlier this year, is modeled after an existing European Union regulation and is known as "China RoHS." While both regulations seek to ban lead and other hazardous substances from a wide range of electrical and electronic products, there are significant differences between the two regulatory approaches. Throughout the process of MII's developing the China RoHS regulation, there was no formal process for interested parties to provide comments or consult with MII, and as a result foreign stakeholders had only limited opportunity to comment on proposals or to clarify MII's implementation intentions. China did eventually notify the regulation to the TBT Committee, but the regulation does not answer questions regarding such basic information as the specific products that will be covered, labeling and marking requirements, maximum limits of hazardous substances and acceptable testing methodologies. MII reportedly finalized standards in some of these areas in November 2006, but they reportedly will not be available until some time in December 2006 and then only upon payment of an unspecified fee. U.S. and other foreign companies are very concerned that they will have insufficient time to adapt their products to China's requirements.

### Standards and Technical Regulations

Shortly after its accession to the WTO, China began the task of bringing its standards regime more in line with international practice. One of its first steps was AQSIQ's issuance of rules designed to facilitate China's adoption of international standards. China subsequently embarked on the task of reviewing all of China's existing 21,000 standards and technical regulations to determine their continuing relevance and consistency with international standards. During the transitional review before the TBT Committee in October 2005, China reported that it had nullified 1,416 national standards. China continued its review of existing standards and technical regulations in 2006, but did not provide an update on its progress.

The United States continues to make efforts to assist China as it improves its standards regime through bilateral exchanges, education and training. For example, in May 2005, a new U.S. private sector standards office, using funding from the U.S. Department of Commerce, opened in Beijing. Its goals are to strengthen ties with Chinese government regulatory authorities, Chinese industry associations and Chinese standards developers and, in particular, to ensure that close communication exists between U.S. and Chinese standards developers. The United States also continued to provide technical assistance to China. Since 2004, this technical assistance has focused on broad standards-development issues, such as the relationship between intellectual property rights and standards, and specific standards in a number of industries, including

information and telecommunications technology, chemicals, steel, petroleum, water conservation, energy efficiency, hydrogen infrastructure, elevators, electrical safety, gas appliances, distilled spirits, heating, ventilation and air conditioning, and building fire safety. The United States has also conducted programs addressing China RoHS and China's new chemical management system.

This year, the U.S. Trade and Development Agency (TDA) launched the U.S.-China Standards and Conformity Assessment Cooperation Project in Beijing. This project, with funding from TDA and U.S. industry, provides education and training to Chinese policy makers and regulators with regard to U.S. standards and conformity assessment procedures. In addition, the American National Standards Institute, with funding and participation from the U.S. Department of Commerce, announced the launching of a Standards Portal in cooperation with SAC. The Standards Portal contains dual language educational materials on the structure, history and operation of the U.S. and Chinese standards systems, a database of U.S. and Chinese standards and access to other standards from around the world.

At the same time, concern has grown over the past few years as China is actively pursuing the development of unique requirements, despite the existence of well-established international standards, as a means for protecting domestic companies from competing foreign standards and technologies. Indeed, China has already adopted unique standards for digital televisions, and it is trying to develop unique standards and technical regulations in a number of other sectors, including, for example, autos, telecommunications equipment, Internet protocols, wireless local area networks, radio frequency identification tag technology, audio and video coding, and fertilizer. This strategy has the potential to create significant barriers to entry into China's market, as the cost of compliance will be high for foreign companies, while China will also be placing its own companies at a disadvantage in its export markets, where international standards prevail.

As previously reported, a particularly troubling example of China's pursuit of unique requirements arose in May 2003, when China issued two mandatory standards for encryption over Wireless Local Area Networks (WLANs), applicable to domestic and imported equipment containing WLAN (also known as Wi-Fi) technologies. These standards, which were originally scheduled to go into effect in December 2003 and were never notified to the TBT Committee, incorporated the WLAN Authentication and Privacy Infrastructure (WAPI) encryption technique for secure communications. This component of the standards differed significantly from the internationally recognized standard that U.S. companies have adopted for global production, and China was set to enforce it by providing the necessary algorithms only to eleven Chinese companies. U.S. and other foreign manufacturers would have had to work with and through these companies, some of which were their competitors, and provide them with technical product specifications, if their products were to continue to enter China's market. Focusing on the WTO compatibility of China's implementation of the standards, the United States repeatedly raised its concerns with China throughout the remainder of 2003 and made WAPI one of the United States' priority issues during the run-up to the April 2004 JCCT meeting. The United States was particularly concerned about the precedent that could be established if China were allowed to

enforce unique mandatory standards in the fast-developing information technology sector. The United States and China were ultimately able to resolve the issue at the JCCT meeting, as China agreed to an indefinite delay in the implementation of the WAPI standards. China has since submitted a voluntary WAPI standard for consideration by the International Organization for Standardization (ISO). The technical merits of the WAPI standard were considered by the ISO in 2005, and its adoption as an international standard was rejected by an ISO vote in March 2006. Separately, China announced in December 2005 that products incorporating the WAPI standards should be given preference in government procurement, although the trade effects of this policy appear to be limited.

The United States also elevated another standards issue to the JCCT level beginning in 2004. The U.S. telecommunications industry was very concerned about increasing interference from Chinese regulators, both with regard to the selection of 3G telecommunications standards and in the negotiation of contracts between foreign telecommunications service providers and their Chinese counterparts. The United States urged China to take a market-based and technology neutral approach to the development of next generation wireless standards for computers and mobile telephones. At the April 2004 JCCT meeting, China announced that it would support technology neutrality with regard to the adoption of 3G telecommunications standards and that telecommunications service providers in China would be allowed to make their own choices about which standard to adopt, depending on their individual needs. China also announced that Chinese regulators would not be involved in negotiating royalty payment terms with relevant intellectual property rights holders. However, by the end of 2004, it had become evident that there was still pressure from within the Chinese government to ensure a place for China's home-grown 3G telecommunications standard.

In 2005, China's regulators continued to take steps to promote that standard, and it also became evident that they had not ceased their attempts to influence negotiations on royalty payments. More recently, in February 2006, China declared TD-SCDMA to be the "national standard" for 3G telecommunications, raising concerns among U.S. and other foreign telecommunications service providers that Chinese mobile telecommunications operators will face Chinese government pressure when deciding what technology to employ in their networks. As a result, the United States again raised the issue of technology neutrality in connection with the April 2006 JCCT meeting. At that meeting, China restated its April 2004 JCCT commitment to technology neutrality for 3G standards, agreeing to ensure that mobile telecommunications operators would be allowed to make their own choices as to which standard to adopt. China also agreed to issue licenses for all 3G standards in a technologically neutral manner that does not advantage one standard over others. The United States will carefully monitor developments in this area in 2007 and re-engage China as necessary to ensure that China's regulators adhere to China's JCCT commitments.

In late 2004, new concerns arose following SAC's issuance of a draft measure – the *Interim Regulations for National Standards Relating to Patents* – and public statements by key Chinese government officials that appeared to call for compulsory licensing of patented technologies that are used for national standards in China. Standards organizations normally require enterprises

that contribute patented technology to a standard to license their patents on “reasonable and non-discriminatory” terms, which entitles them to set reasonable limits on the use of their technology and to receive reasonable compensation. Although the initial draft of this measure did not expressly call for compulsory licensing and subsequent drafts have not been released for public comment, public statements by key Chinese government officials have generated U.S. industry concern that the final version of the measure may require foreign enterprises to share their patented technologies on a royalty-free basis in exchange for the opportunity to participate in developing standards, which is the approach that has been followed by some Chinese standards organizations on an *ad hoc* basis. While the current status of this measure is unclear, the United States has urged China to circulate an updated draft for public comment and will closely monitor developments in this area in 2007. The United States will also closely monitor China’s efforts to develop a new *Standardization Law* in 2007. A draft of that law is reportedly circulating among China’s ministries.

One trade association with broad representation among technology companies aptly summarized the problematic aspects of the Chinese government’s approach to standards as follows: “Technology mandates or promotion of unique national standards are some of the ways China seeks to foster the domestic development of innovative technologies and [intellectual property rights]. This policy is also implemented through direct or indirect interference by Chinese authorities in licensing negotiations between Chinese and foreign technology companies.” The United States agrees with this assessment and will continue to urge China, as a responsible stakeholder in the international trading system, to move away from government intervention and toward greater reliance on private initiative and market mechanisms.

One positive development occurred in August 2006. After several years of bilateral engagement and discussions at the WTO during meetings of the TBT Committee, China notified a proposed revision of its distilled spirits standard and indicated that it was accepting public comment. According to China’s notification, the proposed revision would eliminate the requirement for tolerance levels of superior alcohols, or fusel oil. If adopted, it would bring China’s standard in line with international norms.

### Conformity Assessment Procedures

As previously reported, CNCA regulations establishing a new Compulsory Product Certification System, issued in December 2001, took full effect in August 2003. Under this system, there is now one safety mark, called the “China Compulsory Certification” or “CCC” mark, issued to both Chinese and foreign products. Under the old system, domestic products were only required to obtain the “Great Wall” mark, while imported products needed both the “Great Wall” mark and the “CCIB” mark. In 2006, as in prior years, U.S. companies continued to express concerns that the regulations lack clarity regarding the products that require a CCC mark. They have also reported that China is applying the CCC mark requirements inconsistently and that many domestic products required by CNCA’s regulations to have the CCC mark are still being sold without the mark. In addition, despite the changes made by the regulations, U.S. companies in some sectors continued to express concerns in 2006 about duplication in certification requirements, particularly for radio and telecommunications equipment, medical equipment and automobiles.

Meanwhile, to date, China has granted well over one hundred Chinese enterprises accreditation to test and certify for purposes of the CCC mark. Despite China’s commitment that qualifying minority foreign-owned (upon China’s accession to the WTO) and majority foreign-owned (two years later) joint venture conformity assessment bodies would be eligible for accreditation and would be accorded national treatment, China so far has not granted accreditation to any foreign-invested conformity assessment bodies. China has also not developed any alternative, less trade-restrictive approaches to third-party certification, such as recognition of a supplier’s declaration of conformity. As a result, U.S. exporters to China are often required to submit their products to Chinese laboratories for tests that may be unwarranted or have already been performed abroad, resulting in greater expense and a longer time to market. One U.S.-based conformity assessment body has entered into a Memorandum of Understanding (MOU) with China allowing it to conduct follow-up inspections (but not primary inspections) of manufacturing facilities that make products for export to China requiring the CCC mark. However, China has not been willing to grant similar rights to other U.S.-based conformity assessment bodies, explaining that it is only allowing one MOU per country. Reportedly, Japan has MOUs allowing two conformity assessment bodies to conduct follow-up inspections, as does Germany.

In 2006, as in prior years, the United States raised its concerns about the CCC mark system and China’s failure to allow foreign-invested conformity assessment bodies with China bilaterally and during meetings of the WTO’s TBT Committee, including the transitional review held in November 2006, where it received support from the EC and Japan. The United States will continue to be in close contact with the relevant Chinese authorities in these areas in 2007.

The United States also sought to address one of the more significant problem areas – duplicative certification requirements for imported medical equipment – through the April 2006 JCCT meeting. The United States was able to obtain China’s commitment to eliminate the redundancies to which imported medical equipment has been subjected. To date, however, China has only taken steps to address duplicative product testing. China has not yet addressed



the more burdensome duplicative factory audits and certification requirements applicable to imported electro-medical equipment or additional product-specific concerns, such as redundancies on border inspections for imported pacemakers. The United States raised its concerns in a series of subsequent bilateral meetings in the second half of 2006 as well as during the transitional review before the TBT Committee, held in November 2006. The United States will continue to pursue China's full implementation of this JCCT commitment in 2007.

### ***Other Internal Policies***

#### State-Owned and State-Invested Enterprises

While many provisions in China's WTO accession agreement indirectly discipline the activities of state-owned and state-invested enterprises, China also agreed to some specific disciplines. In particular, it agreed that laws, regulations and other measures relating to the purchase of goods or services for commercial sale by state-owned and state-invested enterprises, or relating to the production of goods or supply of services for commercial sale or for non-governmental purposes by state-owned and state-invested enterprises, would be subject to WTO rules. China also affirmatively agreed that state-owned and state-invested enterprises would have to make purchases and sales based solely on commercial considerations, such as price, quality, marketability and availability, and that the government would not influence the commercial decisions of state-owned and state-invested enterprises. Since China's accession to the WTO, U.S. officials have not heard many complaints from U.S. companies regarding WTO compliance problems in this area, although a lack of available information continues to make it a difficult area to assess. In 2005, however, some U.S. companies began to raise questions about the role of China's government in the decisions of state-owned enterprises contemplating foreign acquisitions, particularly in the oil and gas sector. In addition, in 2006, China issued a number of measures restricting the ability of state-owned and state-invested enterprises to accept foreign investment, as discussed below in the Investment section.

#### State Trading Enterprises

In its WTO accession agreement, China agreed to disciplines on the importing and exporting activities of state trading enterprises. China committed to provide full information on the pricing mechanisms of state trading enterprises and to ensure that their import purchasing procedures are transparent and fully in compliance with WTO rules. China also agreed that state trading enterprises would limit the mark-up on goods that they import in order to avoid trade distortions. Since China's WTO accession, the United States and other WTO members have sought information from China on the pricing and purchasing practices of state trading enterprises, principally through the transitional reviews at the WTO. So far, however, China has only provided general information, which does not allow a meaningful assessment of China's compliance efforts.

#### Government Procurement

The WTO Agreement on Government Procurement (GPA) is a plurilateral agreement and currently covers the United States and 37 other WTO members that have joined it. The GPA applies to the procurement of goods and services by central and sub-central government entities listed by each party, subject to thresholds and certain exceptions. It requires GPA parties to provide MFN and national treatment to the goods, services and suppliers of other GPA parties and to apply detailed procedures designed to ensure fairness and predictability in the procurement process.

At present, China is not a party to the GPA. It committed to become an observer to the GPA upon its WTO accession, and in February 2002 it became an observer to the WTO Committee on Government Procurement. China also committed, in its WTO accession agreement, to initiate negotiations for accession to the GPA “as soon as possible.” In late 2003, MOF established a working group to study the possibility of initiating negotiations for accession to the GPA. In response to questions from the United States, the EC and Japan during the transitional review before the Council for Trade in Goods in November 2004, China stated that the working group was still studying the issue. In 2005, the United States placed more focus on this issue in a series of bilateral meetings leading up to the July 2005 JCCT meeting. At that meeting, China agreed to commence “technical discussions” with the United States and other WTO members in preparation for the initiation of negotiations to join the GPA. The first round of technical discussions between China and the United States took place in February 2006. The United States also supplemented these discussions by pursuing capacity building designed to further educate Chinese policy makers about the GPA and government procurement issues generally. The United States again pressed China to commit to the initiation of negotiations for accession to the GPA by a date certain during the run-up to the April 2006 JCCT meeting. At that meeting, the two sides agreed that China would continue participating in preparatory technical discussions and that China would initiate GPA negotiations by no later than December 2007.

Until it joins the GPA, China has committed in its WTO accession agreement that all of its central and local government entities will conduct their procurements in a transparent manner. China also agreed that, if it opened a procurement to foreign suppliers, it would provide MFN treatment by allowing all foreign suppliers an equal opportunity to participate in the bidding process.

In June 2002, China adopted its *Government Procurement Law*, which became effective in January 2003. This law attempts to follow the spirit of the GPA and incorporates provisions from the United Nations Model Law on Procurement of Goods. The law also directs central and sub-central government entities to give priority to “local” goods and services, with limited exceptions, as China is permitted to do, because it is not yet a party to the GPA. China envisions that this law will improve transparency, reduce corruption and lower government costs. This law is also seen as a necessary step toward reforming China’s government procurement system in preparation for China eventually becoming a party to the GPA. It is notable, however, that the *Government Procurement Law* does not cover tendering and bidding for public works projects, which represent at least one-half of China’s government procurement market. Those projects are

subject to a different regulatory regime, which will have to be harmonized with the regime established by the *Government Procurement Law* before China accedes to the GPA.

China began the process of drafting regulations implementing the *Government Procurement Law* soon after its issuance in June 2002. MOF circulated a draft of these regulations – the *Measures on the Administration of Bidding for Government-Procured Goods and Services* – for public comment in December 2002. The United States submitted written comments and then followed up on them during bilateral meetings with MOF officials. The final regulations, issued in August 2004, set out detailed procedures for the solicitation, submission and evaluation of bids for government contracts relating to goods and services and help to clarify the scope and coverage of the *Government Procurement Law*. MOF also issued several sets of implementing rules, including measures relating to the announcement of government procurements and the handling of complaints by suppliers relating to government procurement.

Meanwhile, as previously reported, beginning in 2003, U.S. companies expressed concerns about implementing rules on government software procurement being drafted by MOF. At a time when China's already large software market was projected to grow by more than 50 percent annually, the initial draft of these rules reportedly contained guidelines mandating that central and local governments – the largest purchasers of software in China – purchase only software developed in China to the extent possible. In response, the United States organized an industry roundtable to inform the relevant Chinese ministries of the views and concerns of interested U.S. trade associations. U.S. industry officials explained that the creation of a domestic software industry cut off from global standards would lead to inefficiencies and would limit, rather than promote, the development of China's software industry. Working closely with U.S. industry, the United States also submitted written comments on the software procurement proposal and followed up by strongly reiterating its concerns with China during a series of bilateral meetings. The United States subsequently made it one of its priority issues during the run-up to the July 2005 JCCT meeting. The United States was concerned not only about U.S. software exporters continuing access to China's large and growing market for packaged and custom software – \$7.5 billion in 2004 – but also about the precedent that could be established for other sectors if China proceeded with MOF's proposed restrictions on the purchase of foreign software by central and local governments. At the JCCT meeting, China took note of the United States' strong concerns and indicated that it would indefinitely suspend the drafting of implementing rules on government software procurement.

Soon afterwards, however, the issue of preferences for the purchase of domestic goods again appeared, when the State Council issued China's *Medium to Long-term Science and Technology Master Plan* in early 2006. The NDRC and several other ministries and agencies are in charge of developing regulations to implement this strategy, which includes preferences for the purchase of domestic goods as an important industrial policy tool. The United States is concerned that these regulations may unfairly discriminate against U.S. firms and is therefore closely monitoring developments in this area.

A similar issue arose in December 2005, when China announced that products incorporating the WAPI standards should be given preference in government procurement, as discussed above (in the Standards and Technical Regulations section). The United States has been monitoring this development, but so far the trade effects of this policy appear to be limited.

As in prior years, the United States will continue to monitor the treatment accorded to U.S. suppliers under the *Government Procurement Law* in 2007 and will continue to urge China to apply its new regulations and implementing rules in a transparent, non-discriminatory manner. In addition, looking ahead to China's accession to the GPA, China's government procurement market is significant in size, and U.S. firms have made clear that China's timely GPA accession is a top priority for them. The United States will therefore continue to encourage China to develop its government procurement system in a manner that will facilitate its accession to the GPA and will seek opportunities to assist China as it undertakes the necessary preparations for that accession.

## **Investment**

Upon its accession to the WTO, China assumed the obligations of the Agreement on Trade-Related Investment Measures (TRIMS Agreement), which prohibits investment measures that violate GATT Article III obligations to treat imports no less favorably than domestic products or the GATT Article XI obligation not to impose quantitative restrictions on imports. The TRIMS Agreement thus expressly requires elimination of measures such as those that require or provide benefits for the incorporation of local inputs (known as local content requirements) in the manufacturing process, or measures that restrict a firm's imports to an amount related to its exports or related to the amount of foreign exchange a firm earns (known as trade balancing requirements). In its WTO accession agreement, China also specifically agreed to eliminate export performance, local content and foreign exchange balancing requirements from its laws, regulations and other measures, and not to enforce the terms of any contracts imposing these requirements. In addition, China agreed that it would no longer condition importation or investment approvals on these requirements or on requirements such as technology transfer and offsets.

Before its accession to the WTO, China began revising its laws and regulations on foreign-invested enterprises to eliminate WTO-inconsistent requirements relating to export performance, local content, foreign exchange balancing and technology transfer. However, some of the revised laws and regulations continue to "encourage" technology transfer, without formally requiring it. U.S. companies remain concerned that this "encouragement" in practice can amount to a "requirement" in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications. Similarly, some laws and regulations "encourage" exportation or the use of local content. Moreover, according to U.S. companies, some Chinese government officials in 2006 – even in the absence of encouraging language in a law or regulation – still consider factors such as export performance and local content when deciding whether to approve an investment or to recommend approval of a loan from a Chinese policy bank, which is often essential to the success of an investment project. The

United States and other WTO members, including the EC and Japan, have raised concerns in this area during the annual transitional reviews conducted by the TRIMS Committee. The United States will continue to follow this situation closely in 2007.

In a separate commitment, as previously reported, China agreed to revise its Industrial Policy for the Automotive Sector to make it compatible with WTO rules and principles by the time of its accession. However, China missed this deadline, and U.S. industry reported that some local officials were continuing to enforce the WTO-incompatible provisions of the policy. In mid-2003, China began circulating a draft of a new automobile industrial policy for review by select domestic enterprises, and some of these enterprises forwarded the draft to their foreign joint venture partners. It was the United States' understanding that this draft, among other things, discouraged the importation of auto parts, sought to restrict imports of complete knocked-down auto kits, and set targets encouraging the use of domestic technology. China was also reportedly considering a requirement that separate distribution channels be used for domestic and imported autos.

In 2003, working closely with U.S. industry, the United States pressed China for full implementation of its commitment to make its automobile industrial policy compatible with WTO rules as well as related commitments scheduled to be phased in over time. In a series of bilateral meetings with China, including the Trade Dialogue meetings held in Beijing in November 2003, the United States made clear that discriminatory industrial policies, whether for the automotive or other sectors, are not in keeping with China's WTO commitments and create unacceptable distortions in China's economy. In addition, the United States and other WTO members, including the EC and Japan, presented their concerns about the types of provisions being considered by China during the transitional reviews before the TRIMS Committee, the Market Access Committee and the Council for Trade in Services in 2003. They also urged China to circulate a draft of the new automobile industrial policy more widely, in accordance with its commitment to provide an opportunity for public comment on new or revised trade-related laws and regulations.

The United States continued to press China bilaterally on this issue in 2004. In May 2004, China issued the final version of its new automobile industrial policy. This policy was revised to eliminate any requirement that separate distribution channels be used for domestic and imported autos, although it continued to include provisions discouraging the importation of auto parts and encouraging the use of domestic technology. This policy also required new automobile and automobile engine plants to include substantial investment in research and development facilities, even though China expressly committed in its WTO accession agreement not to condition the right of investment on the conduct of research and development. The United States, the EC and Japan raised concerns and sought clarifications about various aspects of this policy during the transitional reviews before the Committee on Market Access, the TRIMS Committee and the Council for Trade in Goods in September, October and November 2004.

In 2005, China began to issue measures implementing the new automobile industrial policy. One measure that generated strong criticism from the United States, the EC, Japan and Canada was

the *Measures on the Importation of Parts for Entire Automobiles*, which was issued by the NDRC in February 2005 and became effective in April 2005. These rules impose charges that unfairly discriminate against imported auto parts and discourage automobile manufacturers in China from using imported auto parts in the assembly of vehicles. Specifically, the rules require all vehicle manufacturers in China that use imported parts to register with China's Customs Administration and provide specific information about each vehicle they assemble, including a list of the imported and domestic parts to be used, and the value and supplier of each part. If the number or value of imported parts in an assembled vehicle exceeds specified thresholds, the regulations assess each of the imported parts a charge equal to the tariff on complete automobiles (typically 25 percent) rather than the tariff applicable to auto parts (typically 10 percent). These rules appear to be inconsistent with several WTO provisions, including Article III of GATT 1994 and Article 2 of the Agreement on Trade-Related Investment Measures, as well as the commitment in China's accession agreement to eliminate all local content requirements relating to importation.

At the July 2005 JCCT, China agreed to review its auto parts rules in light of the United States' concerns. The United States subsequently raised its concerns multilaterally through the transitional review before the WTO Committee on Market Access, held in October 2005, as did other WTO Members. In November 2005, the United States again pressed China for action during high-level meetings in Beijing, but China indicated that it was still reviewing the rules.

Further bilateral engagement in early 2006 made clear that China was not prepared to address the United States' concerns and revise the rules on auto parts. Similar efforts by the EC, Japan and Canada were also unsuccessful. In late March and early April 2006, the United States, the EC and Canada initiated dispute settlement against China by filing formal WTO consultations requests. Joint consultations were held in May 2006. However, these consultations did not lead to any serious discussion of possible agreed resolutions. In September 2006, the United States, the EC and Canada filed requests for the establishment of a panel to hear the dispute. A panel was established at the October 2006 meeting of the WTO's Dispute Settlement Body.

China issued another major industrial policy – the Steel and Iron Industry Development Policy – in July 2005. Although many aspects of this new policy have not yet been implemented, it still includes a host of objectives and guidelines that raise serious concerns. As previously reported, this policy restricts foreign investment in a number of ways. For example, it requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. Given that foreign investors are not allowed to have a controlling share in steel and iron enterprises in China, this requirement would seem to constitute a *de facto* technology transfer requirement, in conflict with the commitment in China's accession agreement not to condition investment on the transfer of technology. This policy also appears to discriminate against foreign equipment and technology imports. Like other measures, this policy encourages the use of local content by calling for a variety of government financial support for steel and iron projects utilizing newly developed domestic equipment. Even more troubling, however, it calls for the use of domestically produced steel-manufacturing equipment and domestic technologies whenever domestic suppliers exist, apparently in contravention of the commitment in China's accession

agreement not to condition the right of investment or importation on whether competing domestic suppliers exist.

This policy is troubling because it attempts to dictate industry outcomes and involves the government in making decisions that should be made by the marketplace. It prescribes the number and size of steel producers in China, where they will be located, the types of products that will and will not be produced, and the technology that will be used. This high degree of government direction and decision-making regarding the allocation of resources into and out of China's steel industry raises concerns not only because of the commitment that China made in its WTO accession agreement that the government would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, but also more generally because it represents another significant example of China reverting to a reliance on government management of market outcomes instead of moving toward a reliance on market mechanisms. Indeed, it is precisely that type of regressive approach that is at the root of many of the WTO compliance problems encountered by U.S. industry.

To date, the United States has raised its various concerns with China's new steel policy, both bilaterally and at the WTO. In March 2006, the United States and China held the inaugural meeting of a new JCCT dialogue on the steel industry, made critical by the continuing rapid expansion of China's steel capacity and production and the sharp increase in steel exports from China that began in 2005. The two sides held a second Steel Dialogue meeting in October 2006, with participation from U.S. and Chinese steel industry officials, with the objectives of increasing mutual understanding of the challenges faced by each industry and discussing strategies for addressing trade imbalances, including the benefits of increased reliance on market mechanisms. At the WTO, the United States continued to press its concerns, in regular meetings and through the transitional reviews before the Committee on Import Licensing, the TRIMS Committee and the Subsidies Committee in 2005 and 2006, with support from other WTO members, including Canada, Mexico, the EC and Japan. The United States also focused on China's steel policy in connection with China's first Trade Policy Review at the WTO, held in April 2006. The United States will continue to closely scrutinize China's steel policy and its implementation in 2007.

Meanwhile, in January 2005, as previously reported, the State Council issued a revised *Sectoral Guidelines Catalogue for Foreign Investment*. Like the prior version of this catalogue, issued in March 2002, the revised catalogue generally reflects China's decision to adhere to its commitments to open up certain sectors to foreign investment, although one notable exception involved the importation of books, newspapers, periodicals, electronic publications and audio and video products (as discussed above in the Trading Rights and Distribution Services sections). In addition, while China continued to allow foreign investment in a number of sectors not covered by its WTO accession agreement, one notable exception to this progress continues to be the area of production and development of genetically modified plant seeds, which China still places in the "prohibited" category.

Over the past year, the United States and U.S. industry have become concerned about new restrictions on investment being proposed and implemented by China. Often, these restrictions are accompanied by other problematic industrial policies, such as the increased use of subsidies, preferences for using domestic rather than imported goods, and the development of China-specific standards.

One example can be found in the *State Council Opinions on the Revitalization of the Industrial Machinery Manufacturing Industries*, issued in June 2006. This measure identifies 16 types of equipment manufacturing as the focus of a new initiative, including large equipment for clean and efficient power generation, critical semiconductor manufacturing equipment, civilian aircraft and aircraft engines, pollution control equipment, textiles machinery and large excavators. The new initiative calls for a variety of policy supports designed to promote, develop and expand the market share of domestic companies in these sectors, including preferential import duties on parts and material needed for research and development, encouragement for procuring domestically manufactured new major technical equipment, a dedicated fund to facilitate capital market financing for domestic firms, and strict review of imports. At the same time, the measure indicates that new controls on foreign investment are being contemplated for these sectors, including new approval requirements when foreign entities seek majority ownership or control and the strengthening of the management of equipment and machinery imports.

In August 2006, China made a further move toward a more restrictive investment regime when it issued – without advance notice or an opportunity for public comment – new regulations on mergers and acquisitions (M&A regulations) involving foreign investors. These regulations were the joint effort of MOFCOM, SAT, SAIC, the State-owned Assets Supervision and Administration Commission, the China Securities Regulatory Commission and the State Administration of Foreign Exchange. The regulations strengthen MOFCOM’s supervisory role over foreign investment, in part by requiring MOFCOM’s approval of M&A transactions that it believes impact “national economic security” or involve famous Chinese brands. The regulations also place MOFCOM in the role of determining if the domestic acquisition target has been appropriately valued.

One trade association with broad representation expressed U.S. industry’s concerns succinctly:

In a range of sectors, . . . China appears to be accelerating the implementation of barriers to investment by foreign entities . . . . We are concerned that these restrictions, which will only retard the growth and development of the Chinese economy, are increasingly seen as protectionist tools by industrial planners to shield inefficient or monopolistic enterprises from competition. While we recognize that certain sectors may have particular sensitivity in China due to security or other concerns, the broad application of investment barriers under such auspices – including increasing restrictions on foreign acquisitions of Chinese companies – is a deeply worrisome trend and stands counter to the market-oriented principles that have been the basis for much of China’s economic success over the past few decades.



The United States agrees with this assessment and has raised its concerns, both bilaterally with China and at the WTO during the transitional reviews before the TRIMS Committee and the Council for Trade in Goods, held in October and November 2006. The United States will continue to monitor developments in this area closely in 2007.

## **Agriculture**

Upon its accession to the WTO, China assumed the obligations of the WTO Agreement on Agriculture, which contains commitments in three main policy areas for agricultural products: market access, domestic support and export subsidies. In some instances, China also made further commitments, as specified in its accession agreement.

In the area of market access, WTO members committed to the establishment of a tariff-only regime, tariff reduction and the binding of all tariffs. As a result of its accession negotiations, China agreed to significant reductions in tariff rates on a wide range of agricultural products. China also agreed to eliminate quotas and implement a system of TRQs designed to provide significant market access for certain bulk commodities upon accession. This TRQ system is very similar to the one governing fertilizers (discussed above in the Import Regulation section). China's goods schedule sets forth detailed rules intended to limit the discretion of the agriculture TRQ administrator – originally the State Development and Planning Commission (SDPC), which is now called the NDRC – and to require it to operate with transparency and according to precise procedures for accepting quota applications, allocating quotas and reallocating unused quotas.

In the area of domestic support, the basic objective is to encourage a shift in policy to the use of measures that minimize the distortion of production and trade. Essentially, WTO members committed to reduce over time the types of domestic subsidies and other support measures that distort production and trade, while WTO members remain free to maintain or even increase support measures that have little or no distorting effect, such as agricultural research or training by the government. China committed to a cap for trade- and production-distorting domestic subsidies that is lower than the cap permitted for developing countries and that includes the same elements that developed countries use in determining whether the cap has been reached.

In the area of export subsidies, WTO members committed to ban the use of these subsidies unless they fall within one of four categories of exceptions, the principal one of which allows export subsidies subject to certain reduction commitments. However, like many other WTO members, China agreed to eliminate all export subsidies upon its accession to the WTO and did not take any exceptions.

Another important agricultural area is covered by the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement), under which China also became obligated. The SPS Agreement establishes rules and procedures regarding the formulation and application of sanitary and phytosanitary measures, i.e., measures taken to protect against risks associated with plant or animal borne pests and diseases, additives, contaminants, toxins and disease-causing organisms in foods, beverages or feedstuffs. The rules and procedures in the

SPS Agreement require that sanitary and phytosanitary measures address legitimate human, animal and plant health concerns, do not arbitrarily or unjustifiably discriminate between WTO members' agricultural and food products, and are not disguised restrictions on international trade. The SPS Agreement requires that the measures in question be based on scientific grounds and developed through risk assessment procedures, while at the same time it preserves each member's right to choose the level of protection it considers appropriate with regard to sanitary and phytosanitary risks.

Other WTO agreements also place significant obligations on China in the area of agriculture. Three of the most important ones are GATT 1994, the Import Licensing Agreement and the TBT Agreement, which are discussed above (in the sections on Import Regulation and Internal Policies Affecting Trade).

China also made several additional commitments intended to rectify other problematic agricultural policies, either upon accession or after limited transition periods. For example, China agreed to permit non-state trading enterprises to import specified TRQ shares of wheat, corn, rice, cotton, wool and vegetable oil, although these products had been subject to import monopolies by state trading enterprises.

While tariff reductions have certainly encouraged U.S. exports to China, which continued to reach record highs in 2006, the increases continued to be largely the result of greater demand. At the same time, a variety of non-tariff barriers continued to impede agricultural trade with China, particularly in the area of sanitary and phytosanitary measures, where China's actions often have not appeared to be guided by scientific principles. As in prior years, the United States and China have been able to resolve some of these issues through protracted negotiations, but others appear to have reached an impasse.

On the positive side, U.S. agricultural products continued to experience strong sales to China. China is now the United States' fourth largest agricultural export market, as U.S. exports to China totaled \$4.8 billion from January through September 2006, a significant increase (42 percent) over the same period in 2005, another very successful year. In fact, in 2005, U.S. agricultural exports exceeded \$5.2 billion, more than twice the level in 2002 and more than five times the level in 1999.

Meanwhile, commitments announced at the April 2004, July 2005 and April 2006 JCCT meetings on the issue of U.S. beef market access to China following the discovery of bovine spongiform encephalopathy (BSE) in two U.S. cows and one cow imported to the United States from Canada resulted only in limited and sporadic progress. This issue is emblematic of the continuing problems U.S. exporters face with non-transparent application of sanitary and phytosanitary measures, many of which have appeared to lack scientific bases and have impeded market access for many U.S. agricultural products.

China's unnecessary and seemingly arbitrary inspection-related import requirements also continued to impose burdens and regulatory uncertainty on U.S. agricultural producers exporting

to China in 2006. In addition, registration requirements for animal feeds were unnecessarily burdensome and limited the ability of U.S. exporters to access China's market, while China's administration of TRQs on bulk agricultural commodities was still not functioning entirely as envisioned in China's WTO accession agreement, as it continued to be impaired by inadequate transparency.

In 2007, as in prior years, the United States will continue to pursue vigorous bilateral engagement with China in order to obtain progress on its outstanding concerns. As part of this effort, the United States will continue to use the high-level U.S.-China agricultural working group, created at the April 2004 JCCT meeting, as a vehicle to address each side's concerns in the agriculture area.

### ***Tariffs***

China implemented the required tariff changes on agricultural goods for 2006 on schedule on January 1, 2006, just as it did for industrial goods. These changes increased market access for many U.S. agricultural exporters, as China continued the scheduled reduction of tariffs on agricultural goods. As previously reported, tariffs of greatest importance to U.S. farmers and ranchers are being lowered from a 1997 average of 31 percent to 14 percent, in almost all cases over a period of five years running from January 1, 2002, or by January 1, 2006.

The tariff reductions made by China, coupled with increased demand, contributed to a marked increase in certain U.S. exports to China. Exports of some bulk agricultural commodities have increased dramatically in recent years, and continue to perform strongly, including soybeans and cotton. Exports of forest products such as lumber continued to perform strongly, increasing by 15 percent for the first nine months of 2006, with a projected year-end total of \$550 million. Fish and seafood exports, after having increased from \$119 million in 2001 to \$135 million in 2002, and then to \$176 million in 2003 and \$258 million in 2004, rose to \$351 million in 2005 and by another 25 percent in the first nine months of 2006 and were projected to reach \$450 million by the end of the year. Meanwhile, exports of consumer-oriented agricultural products increased by 32 percent from January through September 2006, when compared to the same period in 2005, and were projected to exceed \$650 million by the end of they year.

However, the full market access potential of China's tariff cuts was not realized for some products. As discussed below, a variety of non-tariff barriers continue to impede market access for U.S. agricultural exports to China, particularly exports of consumer-ready and value-added products.

### ***China's Biotechnology Regulations***

As previously reported, one of the most contentious agriculture issues that arose during China's first year of WTO membership involved new rules implementing June 2001 regulations relating to biotechnology safety, testing and labeling. The implementing rules, issued by China's Ministry of Agriculture (MOA) shortly before China's WTO accession, did not provide adequate

time for scientific assessment and the issuance of formal safety certificates for biotechnology products. As the March 2002 effective date for these implementing rules approached, trade in biotechnology products began to be disrupted. The U.S. products most affected were soybeans, which had seen exports to China grow to more than \$1 billion in 2001, while corn and other products, such as consumer products made from biotech commodities, remained at risk. Following concerted, high-level pressure from the United States, China agreed to a temporary solution in March 2002, which provided for a nine-month delay, effected through the issuance of temporary safety certificates, good through December 20, 2002. When it became apparent that this extension would not be sufficient, further high-level engagement produced another agreed extension until September 2003 and later an extension until April 2004. China finally issued a formal safety certificate for a U.S. biotechnology soybean variety known as Roundup Ready soybeans in February 2004. In addition, by the time of the April 2004 JCCT meeting, China had also issued formal safety certificates for six corn events, seven canola events and two cotton events. China issued a formal safety certificate for another corn event a few months later, leaving only one corn event still awaiting formal approval. China issued a formal safety certificate for this last corn event at the time of the July 2005 JCCT meeting.

With some stability added to the China soybean market through the extensions in 2003 and the issuance of the formal safety certificate for Roundup Ready soybeans in February 2004, U.S. exports of soybeans performed strongly. In 2003, U.S. soybean exports reached a record level of \$2.9 billion, representing an increase of 190 percent over 2002. In 2004, U.S. soybean exports declined to \$2.3 billion, although this figure was still twice the level of any year prior to 2003. In 2005, U.S. soybean exports remained approximately steady at \$2.2 billion. In the first nine months of 2006, U.S. soybean exports totaled \$1.3 billion, an increase of 12 percent over the same period in 2005, and China remained the leading export destination for U.S. soybeans.

Meanwhile, other U.S. concerns with China's biotechnology regulations and implementing rules remain. For example, China requires a product to be approved in the United States before it can be submitted in China for approval, and China allows only two new product applications each year. Both of these practices present significant and unnecessary delays for bringing U.S. goods into the China market. China's lack of clarity on the requirements applicable to products stacked with multiple traits is a cause for additional concern, as are China's sometimes duplicative and unprecedented testing requirements.

In November 2006, MOA finally issued an announcement about the renewal requirements for safety certificates covering biotechnology crops imported for processing purposes. Because safety certificates for cotton, soybeans, corn and canola are due to expire beginning in February 2007, it is possible that trade in these products may be disrupted, depending on how the approval process works. Indeed, even if the approval process proceeds quickly, trade may still be disrupted, as importers need time to apply for vessel-based safety certificates and Quarantine Inspection Permits, both of which require valid safety certificates for biotechnology products and can take up to 30 working days.

A high-level U.S.-China biotechnology working group that was formed in July 2002 is discussing these and other issues. In addition, a newly created subgroup of experts focuses on specific, technical issues. Together, these two groups have made substantial progress, and they will continue to work through the range of issues in 2007.

### ***Tariff-rate Quotas on Bulk Agricultural Commodities***

Another issue of particular concern involves China's commitments relating to TRQs on bulk agricultural commodities, which include several commodities of particular importance to U.S. farmers, such as wheat, corn, cotton and vegetable oils. Since SDPC (and later NDRC) began implementing these commitments following China's accession, a series of problems have undermined the market access envisioned by WTO members. Although progress has been made on some of these issues, NDRC's lack of transparency continues to create significant concern.

As previously reported, in 2002, the first year of this TRQ system, it appeared that SDPC had decided to allocate TRQs in a manner that would protect domestic farm interests and maintain the monopoly enjoyed by state trading enterprises. SDPC operated with only limited transparency, refusing to provide specific details on the amounts and the recipients of the allocations. At the same time, SDPC reserved a significant portion of the TRQs for the processing and re-export trade, despite China's commitment to provide market access and national treatment for imported products. SDPC also allocated a portion of the TRQs for some commodities in smaller than commercially viable quantities, and it employed burdensome licensing requirements. As these problems became apparent, the United States repeatedly engaged China bilaterally, at all levels of government, and it also raised its concerns at the WTO during meetings of the Committee on Agriculture. In July 2002, the United States requested formal consultations with China under the headnotes contained in China's WTO goods schedule, and those consultations took place in September 2002 in Geneva.

Following the 2003 TRQ allocations, it became clear that the most serious first-year problems – lack of transparency, sub-division of the TRQ, small allocation sizes and burdensome licensing – persisted. The United States again engaged China bilaterally on several occasions, culminating with high-level meetings in Beijing in June 2003. At these meetings, China agreed to take steps to address most of the United States' concerns. China followed through on its June 2003 commitments in part in October 2003, when NDRC issued new regulations for shipments beginning January 1, 2004. Key changes made by these regulations include the elimination of separate allocations for general trade and processing trade, the elimination of certain unnecessary licensing requirements, and the creation of a new mechanism for identifying allocation recipients.

In 2004, as the United States focused on how NDRC was enforcing its new regulations in a series of bilateral meetings during the run-up to the April 2004 JCCT meeting, improvements in NDRC's TRQ administration became evident. NDRC implemented the regulatory provision calling for the elimination of separate allocations for general trade and processing trade, increased the size of quota allocations, and improved its handling of reallocations. At the same

time, transparency continues to be problematic, although some improvement did take place for some of the commodities subject to TRQs.

While these systemic changes were taking place, exports of some bulk agricultural commodities from the United States continued to show substantial increases, largely due to market conditions. In particular, despite some continuing problems with NDRC's handling of the cotton TRQs, U.S. cotton exports totaled a record \$1.4 billion in 2004 and \$1.4 billion again in 2005. U.S. wheat exports totaled an unusually high amount of \$495 million in 2004, as the TRQ allocations for wheat did not appear to act as a limiting factor, and then \$79 million for 2005, still substantially above the years prior to 2004.

Throughout 2006, the United States continued to raise transparency and other concerns, both in bilateral meetings and during the transitional review before the WTO's Committee on Agriculture in October 2006. In 2007, the United States will continue to work to ensure that NDRC administers TRQs transparently and in a manner that is consistent with China's commitments and that does not impede market access or commercial decisions.

### *Sanitary and Phytosanitary Issues*

In 2006, China's SPS measures continued to pose a serious problem for U.S. agricultural producers exporting to China. As in prior years, the United States repeatedly engaged China on a number of SPS issues, both in bilateral meetings, including high-level meetings, and during meetings of the WTO's SPS Committee, including the transitional review held in October 2006. The United States also continued to provide training to China's regulatory authorities. As discussed below, however, little progress has been achieved to date, except in the case of the Avian Influenza (AI) bans and, to a limited extent, the BSE-related ban on low-risk bovine products. In many instances, progress was made difficult by China's inability to provide relevant risk assessments or the science-based rationale for maintaining its import restrictions against U.S.-origin products. For example, in 2006, China was unable to provide a science-based rationale for maintaining import restrictions on U.S. beef products and some U.S. poultry and pork products, as described below. The United States will continue to press for resolution of these and other outstanding issues in 2007.

#### BSE-Related Bans on Beef and Low-Risk Bovine Products

In December 2003, China and other countries imposed a ban on imports of U.S. cattle, beef and processed beef products in response to a case of BSE found in the United States. Since that time, the United States has repeatedly provided China with extensive technical information on all aspects of its BSE-related surveillance and mitigation measures, internationally recognized by the Office International des Epizooties (OIE) as effective and appropriate, for both food safety and animal health. After three years, China still has not provided any scientific justification for continuing to maintain its ban.

At the July 2005 JCCT meeting, China did finally agree to send a technical team to the United States to gather information on the United States' surveillance and mitigation measures and to follow a transparent, science-based process leading to the eventual lifting of the ban. The technical team's visit took place in late October 2005, but no further progress was evident until the April 2006 JCCT meeting, when China agreed to conditionally reopen the Chinese market to U.S. beef, subject to the negotiation and finalization of a protocol by technical experts on an expedited basis. Jointly negotiated protocols, and accompanying export certificates, are normal measures necessary for the export of any livestock products from the United States to China or other trading partners.

At the end of June 2006, after three inconclusive rounds of negotiations in May and June 2006, China's food safety regulators unilaterally announced a limited market opening, restricted to the entry of U.S. boneless beef thirty months of age or less, and one month later they followed up that announcement with an announcement of 22 onerous entry conditions. These unilateral announcements had no practical effect, because, as with any trading partners seeking to engage in livestock trade, the United States and China would have had to agree on language for actual export safety certificates before the trade could resume. Since the June and July 2006 announcements by China, the United States has asked China to review its position on this issue in light of OIE guidelines and to re-engage with U.S. officials, as China's ongoing restrictions raise serious questions with regard to China's obligations under the SPS Agreement, taking into account the relevant international standards governing beef trade. U.S. and Chinese officials are scheduled to meet in Beijing in December 2006 to discuss this issue.

At the same time that it banned U.S. cattle, beef and processed beef products, China also banned bovine-origin products (i.e., bovine semen, bovine embryos, and protein-free tallow) that are listed in OIE guidelines as safe to trade regardless of a country's BSE status. Additionally, China banned imports of U.S.-origin non-ruminant feeds and fats (such as pet food, rendered products and porcine proteins) even though these products were of non-bovine-origin and presented absolutely no BSE-related risk. After numerous bilateral meetings and technical discussions in 2004, including a visit to U.S. bovine facilities by Chinese food safety officials, China announced a lifting of its BSE-related ban for these "low-risk" products in late September 2004. However, China conditioned the lifting of the ban on the negotiation of protocol agreements setting technical and certification parameters for incoming low-risk products. In November 2004, U.S. and Chinese officials finalized and signed amended protocols that would enable the resumption of exports of U.S.-origin bovine semen and bovine embryos, contingent on facility-by-facility certification by China's regulatory authorities in accordance with the original protocols that were signed more than 10 years prior. Additionally, U.S. and Chinese authorities signed a new protocol which authorized a resumption of exports of U.S.-origin non-ruminant feeds and fats. In July 2005, during the run-up to the JCCT meeting, China finally announced the resumption of trade in bovine semen and bovine embryos, following facility certifications completed in June 2005. However, it was not until early 2006 that imports of U.S.-origin bovine semen and bovine embryos actually resumed. Additionally, in June 2005, China agreed to accept a systems approach audit (as opposed to facility-by-facility certification) to approve U.S. facilities to export U.S.-origin non-ruminant feeds and fats (pet food, rendered

products, porcine proteins, etc.) to China. The initial shipment of U.S.-origin non-ruminant pet food occurred in September 2005. By January 2006, trade in the full range U.S.-origin non-ruminant feed and fat products had also resumed, after negotiation and resolution of a series of onerous, detailed and unnecessary non-BSE related information requirements proposed by China that are not consistent with OIE guidelines and contrast sharply with U.S. requirements. To date, trade in protein-free tallow (a product listed by the OIE as safe to trade regardless of a country's BSE status) has still not resumed, as U.S. and Chinese officials continue to be unable to reach agreement on provisions of a protocol.

#### Pathogen Standards and Residue Standards for Raw Meat and Poultry Products

Since 2002, as previously reported, China has applied SPS-related requirements on imported raw meat and poultry that do not appear to be consistent with Codex Alimentarius (Codex) guidelines or current scientific testing practices. One requirement establishes a zero tolerance limit for the presence of Salmonella bacteria. Similar zero tolerance standards exist for E. Coli and Listeria pathogens. Meanwhile, the complete elimination of these enteropathogenic bacteria is generally considered unachievable without first subjecting raw meat and poultry to a process of irradiation. Moreover, China apparently does not apply this same standard to domestic raw poultry and meat, raising national treatment concerns.

In late 2005 and early 2006, 14 U.S. pork and poultry plants were de-listed by China for alleged violations of zero tolerance standards for pathogens or detection of certain chemical residues. Despite positive results from USDA Food Safety and Inspection Service investigations of the plants, the majority of the plants were not re-listed as approved to ship product to China until April 2006, following extensive engagement between U.S. and Chinese regulatory officials because of differences between Codex guidelines and China's SPS-related requirements on imported raw meat and poultry. Two U.S. plants remain de-listed while U.S. regulatory officials continue to press Chinese regulatory officials to re-list the plants or provide scientific justification.

Meanwhile, China continues to maintain maximum residue levels (MRLs) for certain heavy metals, veterinary drugs and other residues that are inconsistent with Codex and other international standards. China also enforces a "zero tolerance" for some residues, even where Codex has adopted guidelines that many of China's major trading partners have adopted. U.S. regulatory officials have encouraged their Chinese counterparts to adopt MRLs that are scientifically based, safe and minimally trade-disrupting. This effort will continue in 2007.

#### Avian Influenza

In February 2004, as previously reported, China imposed a nationwide ban on U.S. poultry in response to cases of low-pathogenic AI found in Delaware. Throughout 2004, the U.S. provided technical information to China on the U.S. AI situation, and in August a high-level Chinese delegation conducted a review of the status of AI eradication efforts in the United States. In



December 2004, China lifted its nationwide ban on U.S. poultry, leaving in place a ban only for the states of Connecticut and Rhode Island.

In early 2005, following the announcement of low-pathogenic AI found in the state of New York, China did not impose a nationwide ban. Instead, demonstrating progress in following OIE guidelines, China imposed a ban limited to poultry from the state of New York.

In 2006, China imposed an import ban for poultry and poultry products originating from the state of Pennsylvania, based on incidents of low-pathogenic AI. China also suspended the importation of heat-treated and cooked poultry and poultry products at the same time, even though the OIE's AI chapter makes clear that products that have been heat-treated in a manner to inactivate the virus should not be subject to an AI-related import ban. The United States is attempting to work with China's regulators to address this situation.

### Wheat

As previously reported, the 1999 U.S.-China Agricultural Cooperation Agreement established an agreed level of TCK fungus tolerance in U.S. wheat, and China no longer routinely blocks U.S. wheat exports from the Pacific Northwest on the basis of the TCK fungus. Nevertheless, China has imposed an MRL for selenium that is below the international standard and threatens all U.S. wheat exports to China. In addition, China has imposed an MRL for vomitoxin in wheat in the absence of any international standard. Although these measures are problematic, U.S. exports of wheat to China in 2006 do not appear to have been impacted by these measures, as China still appears not to be enforcing them.

### Food Additive Standards

Another problematic area involves China's overly restrictive food additive standards. China continues to block many U.S. processed food products from entering the Chinese market by banning certain food additives that are widely used in other countries and have been approved by the World Health Organization. One recent example is China's proposed *Hygienic Standard for Uses of Food Additives*, notified to the WTO's TBT Committee in July 2005 so that WTO members could comment on it. This proposed technical regulation is 237 pages long and covers dozens of residues and additives for nearly 1,000 commodities. In some cases, it employs domestic nomenclature rather than internationally recognized technical terms, making it difficult to assess the impact that it would have on specific products. The United States submitted detailed comments on the proposed technical regulation and asked China to delay adoption of it until a thorough review could take place. To date, China has not issued its *Hygienic Standard for Uses of Food Additives* in final form.

### Fire Blight

Beginning before its accession to the WTO, China had imposed quarantine restrictions on all but two varieties of U.S. apples and all U.S. plum varieties as well as other U.S. stone fruit, allegedly

due to phytosanitary concerns regarding fire blight. However, the WTO Appellate Body report in *Japan - Measures Affecting the Importation of Apples (Japan-Apples)*, issued in November 2003, determined that these concerns are unwarranted for imports of mature symptomless fruit. Throughout 2004 and 2005, the United States urged China to allow U.S. exports of mature symptomless fruit, consistent with *Japan-Apples*, both in bilateral meetings and at the WTO during regular meetings and the annual transitional reviews before the SPS Committee. In December 2005, China agreed no longer to impose fire blight-related restrictions on imports of U.S. plum varieties, as U.S. and Chinese regulatory officials reached agreement on import conditions.

### ***Inspection-related Requirements***

Through two measures – the *Administrative Measures for the Entry-Exit Inspection and Quarantine for Grains and Feed Stuff*, which became effective on March 1, 2002, and the *Administrative Measures for Entry Animal and Plant Quarantine*, which became effective September 1, 2002 – AQSIQ requires importers to obtain a Quarantine Inspection Permit, or QIP, prior to signing purchase contracts for nearly all traded agricultural commodities. QIPs are one of the most important trade policy issues affecting the United States and China's other agricultural trading partners.

AQSIQ sometimes slows down or even suspends issuance of QIPs at its discretion, without notifying traders in advance or explaining its reasons, resulting in significant commercial uncertainty. Because of the commercial necessity to contract for commodity shipments when prices are low, combined with the inherent delays in having QIPs issued, many cargoes of products such as soybeans, meat and poultry arrive in Chinese ports without QIPs, creating delays in discharge and resulting in demurrage bills for Chinese purchasers. In addition, traders report that shipment quantities are often closely scrutinized and are at risk for disapproval if considered too large.

Some improvements were made to the QIP system in 2004 following repeated engagement bilaterally and through interventions made by the United States and other WTO members during the transitional reviews before the SPS Committee and the Committee on Import Licensing in 2002 and 2003. In June 2004, fulfilling a Chinese commitment made in connection with the April 2004 JCCT meeting, AQSIQ issued Decree 73, the *Items on Handling the Review and Approval for Entry Animal and Plant Quarantine*, which extended the period of validity for QIPs from three months to six months. AQSIQ also began issuing QIPs more frequently within the established time lines. Nevertheless, a great deal of uncertainty remains even with the extended period of validity, because a QIP still locks purchasers into a very narrow period to purchase, transport and discharge cargoes or containers before the QIP's expiration, and because AQSIQ continues to administer the QIP system in a seemingly arbitrary manner.

Traders continue to be hesitant to press AQSIQ for change because they would risk falling out of favor. Many traders would at least like AQSIQ to eliminate the quantity requirements that it unofficially places on QIPs. These quantity requirements have been used often by AQSIQ

during peak harvest periods to limit the flow of commodity imports. In 2006, traders reported that MOFCOM not only limited QIP quantities, but also required some companies to use up the majority of a QIP before being issued another one and required other companies to use up their QIPs or risk being “de-listed.” Eliminating these requirements would make the QIP system more dependent on market forecast.

Little improvement in the QIP system has taken place over the last two years. AQSIQ officials continue to insist that the QIP system ensures that an adequate number of examiners are on duty at ports when shipments arrive to certify and inspect them for quality and quantity, while the United States and other WTO members argue that there does not appear to be any scientific basis for the QIP system and that it serves as an unjust and overly restrictive barrier to trade. The United States will continue to press China on this important issue in 2007.

Meanwhile, MOFCOM administers a separate import permit system for commodities such as poultry products. Through its issuance of Automatic Registration Forms (ARFs) to importers, MOFCOM allocates a volume amount to an importer for imports of particular commodities each year. During 2005 and 2006, U.S. officials continued to encourage MOFCOM to issue these ARFs in a more transparent, flexible manner so that trade is not disrupted.

### ***Export Subsidies***

Since shortly after China’s accession to the WTO, U.S. industry has been concerned that China provides export subsidies on corn, despite China’s WTO commitment to eliminate all export subsidies upon accession to the WTO. In past years, it appeared that significant quantities of corn had been exported from China, including corn from Chinese government stocks, at prices that may have been 15 to 20 percent below domestic prices in China. As a result, U.S. corn exporters were losing market share for corn in their traditional Asian markets, such as South Korea and Malaysia, while China was exporting record amounts of corn.

Since 2002, the United States has pressed its concerns about possible export subsidies on corn with China bilaterally, including in high-level meetings. The United States has also raised its concerns and has sought additional information about China’s corn policies – including the use of potentially excessive VAT rebates – during meetings before the Committee on Agriculture, including the transitional reviews.

In 2004, trade analysts began to conclude that, because of several economic factors, primarily falling stock levels and burgeoning domestic demand, China was trending toward eventually becoming a net importer of corn. One result appears to be that China’s exports are largely being made on a commercial basis, although concern remains regarding the operation of China’s VAT rebate system for corn.

The United States will continue to investigate China’s subsidization practices and VAT rebate system for the agricultural sector in 2007. The United States will make every effort to ensure that any use of export subsidies is eliminated.

## **Intellectual Property Rights**

With its acceptance of the TRIPS Agreement, China took on obligations to adhere to generally accepted international norms to protect and enforce the intellectual property rights held by U.S. and other foreign companies and individuals in China. Specifically, the TRIPS Agreement sets minimum standards of protection for copyrights and neighboring rights, trademarks, geographical indications, industrial designs, patents, integrated-circuit layout designs and undisclosed information. Minimum standards are also established by the TRIPS Agreement for IPR enforcement in administrative and civil actions and, in regard to copyright piracy and trademark counterfeiting, in criminal actions and actions at the border. The TRIPS Agreement requires as well that, with very limited exceptions, WTO members provide national and most-favored-nation treatment to the nationals of other WTO members with regard to the protection and enforcement of intellectual property rights.

Since its accession to the WTO, China has overhauled its legal regime and put in place a comprehensive set of laws and regulations aimed at protecting the intellectual property rights of domestic and foreign entities in China. At the same time, some key improvements in China's legal framework are still needed, and China has continued to demonstrate little success in actually enforcing its laws and regulations in the face of the challenges created by widespread counterfeiting, piracy and other forms of infringement. Indeed, USTR's April 2006 report under the Special 301 provisions of U.S. trade law cited inadequate IPR enforcement as one of China's greatest shortcomings as a trading partner. As a result, in 2006, the United States' bilateral engagement with China continued to focus on obtaining improvements to multiple aspects of China's system of IPR protection and enforcement so that significant reductions in IPR infringement in China could be realized and sustained over time.

Several factors contribute to China's poor IPR enforcement record. One major factor is China's chronic underutilization of deterrent criminal remedies. Legal measures in China that establish high thresholds for criminal investigation, prosecution and conviction preclude criminal remedies in many instances of commercial-scale counterfeiting and piracy, creating a "safe harbor" for infringers and raising concerns among the United States and some of its major trading partners that China may not be complying with its obligations under Article 61 of the TRIPS Agreement. With criminal remedies circumscribed, China's enforcement authorities rely instead on toothless administrative enforcement, which primarily results in small fines, administrative injunctions and other minor inconveniences for infringers. As discussed above in the sections on Trading Rights and Distribution Services, another exacerbating factor – which also raises specific WTO concerns – is China's continued maintenance of import restrictions and restrictions on wholesale and retail distribution that reduce and delay market access for certain types of legitimate foreign products, such as movies, video games and books, inadvertently helping to ensure that infringing products continue to dominate those sectors within China.

China's leaders began to demonstrate a willingness to address U.S. concerns in October 2003, when a new IPR Leading Group was formed, signaling a more focused and sustained effort by

China to tackle the IPR enforcement problem. Many officials in China, led by President Hu Jintao, Premier Wen Jiabao and Vice Premier Wu Yi, continued to give voice to China's commitment to protecting intellectual property rights in 2006 and worked hard to make it a reality, as they allocated substantial resources to the effort and attempted to improve not only public awareness but also training and coordination among the numerous Chinese government entities involved in IPR enforcement while simultaneously fighting local protectionism and corruption. Sustained involvement by China's leaders is critical if China is to deliver on the IPR commitments that it made at the April 2004, July 2005 and April 2006 JCCT meetings, including China's core commitment to significantly reduce IPR infringement levels across the country.

As previously reported, building on earlier engagement with China, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law in 2004 and 2005. This review involved a systematic evaluation of China's entire IPR enforcement regime and concluded in April 2005 with the Administration's elevation of China to the Special 301 "Priority Watch" list and the creation of a comprehensive strategy for addressing China's ineffective IPR enforcement regime, which included the possible use of WTO mechanisms, as appropriate.

Pursuing this new strategy at the July 2005 JCCT meeting, the United States sought and obtained China's agreement to take a series of specific actions designed to (1) increase criminal prosecutions of IPR violators, (2) improve enforcement at the border, (3) counter piracy of movies, audio-visual products and software, (4) address Internet-related piracy and (5) assist small and medium-sized U.S. companies experiencing China-related IPR problems, among other things. To date, China has taken steps to fulfill many of these commitments. It adopted amended rules governing the transfer of administrative and customs cases to criminal authorities, and it took some steps to pursue administrative actions against end-user software piracy. China posted an IPR Ombudsman to its Embassy in Washington, who has facilitated contacts between U.S. government officials and their counterparts in Beijing, and has been a source of information for U.S. businesses, including small and medium-size companies. China has also sought to expand enforcement cooperation.

Meanwhile, in October 2005, the United States submitted a request to China under Article 63.3 of the TRIPS Agreement, as did both Japan and Switzerland, seeking more transparency on IPR infringement levels and enforcement activities in China, with the objective of obtaining a better basis for assessing the effectiveness of China's efforts to improve IPR enforcement since China's accession to the WTO. However, despite the United States' extensive efforts to follow up on its Article 63.3 request bilaterally, China has since provided only limited information in response, hampering the United States' ability to evaluate whether China is taking all necessary steps to address the rampant IPR infringement found throughout China.

In 2006, the United States again used the JCCT process, including the IPR Working Group created at the April 2004 JCCT meeting, to secure new IPR commitments and, in a few instances, specific actions to implement past commitments. During the run-up to the April 2006 JCCT meeting, China took enforcement actions against plants that produce pirated optical discs,

and it also issued new rules that require computers to be pre-installed with licensed operating system software. At the meeting itself, China further committed to ensure the legalization of software used in Chinese enterprises and to take up issues of government and enterprise software asset management in the JCCT IPR Working Group. China also agreed to work on cooperation to combat infringing goods displayed at trade fairs in China and to intensify efforts to eliminate infringing products at major consumer markets in China, such as the Silk Street Market in Beijing. The two sides further agreed that they would increase cooperation between their respective law enforcement authorities and customs authorities and that the United States would provide China with additional technical assistance to aid China in fully implementing the WIPO Internet treaties, i.e., the WIPO Copyright Treaty and the WIPO Performance and Phonograms Treaty. In addition, China reaffirmed its prior commitments to continue efforts to ensure use of legalized software at all levels of government and to adopt procedures to ensure that enterprises use legal software, beginning with state-owned enterprises and other large enterprises.

To date, China has made some progress in implementing its April 2006 JCCT commitments, but it has been slower than in the past. One bright spot appears to be China's implementation of the new rules requiring computers to be pre-installed with licensed operating system software, as U.S. industry has been pleased with the initial results of that effort.

### ***Legal Framework***

In most respects, China's framework of laws, regulations and implementing rules remains largely satisfactory. However, reforms are needed in a few key areas, including certain aspects of the *Criminal Law* and rapidly emerging fields, such as Internet copyright protection. In particular, right holders have pointed to a number of continuing deficiencies in China's criminal measures. Most notably, it appears that China needs to eliminate thresholds for criminal prosecution that provide a legal "safe harbor" for many commercial infringers if it is to bring its legal framework into compliance with its TRIPS Agreement obligations. In addition, while China introduced new regulations in 2006 that represent a positive step toward meeting the requirements of the WIPO Internet treaties, more work is needed at both the national level and the provincial level to meet the challenges of Internet piracy and fully implement the WIPO Internet treaties.

As previously reported, at the time of its accession to the WTO, China was in the process of modifying the full range of IPR laws, regulations and implementing rules, including those relating to patents, trademarks and copyrights. China had completed amendments to its *Patent Law*, *Trademark Law* and *Copyright Law*, along with regulations for the *Patent Law*. Within several months after its accession, China issued regulations for the *Trademark Law* and the *Copyright Law*, followed by implementing rules. China also issued regulations and implementing rules covering specific subject areas, such as integrated circuits, computer software and pharmaceuticals. U.S. experts carefully reviewed these measures after their issuance and, together with other WTO members, participated in a comprehensive review of them as part of the first transitional review of China before the TRIPS Council in 2002.

Since 2003, China has periodically issued new IPR measures. The U.S. Government has reviewed these measures through bilateral discussions and subsequent TRIPS Council reviews. Encouragingly, China has also become more willing to circulate proposed measures for public comment and to discuss proposed measures with interested trading partners and stakeholders. For example, the United States and U.S. right holders provided written comments to China on several drafts of regulations for the protection of copyrights on information networks.

In 2006, China announced a new Action Plan for revising its legal regime in order to better protect intellectual property rights. Among other things, this Action Plan sets out China's intentions for revising the *Patent Law*, the *Trademark Law* and related measures, and China subsequently did release new versions of both the *Patent Law* and the *Trademark Law* for public comment. Since then, the United States has been assessing the potential ramifications of the contemplated revisions for U.S. right holders. The U.S. Government and U.S. industry groups have also submitted written comments, along with invitations to continue dialogue on these important pieces of legislation.

China has also been working on other proposed legal measures that could have significant implications for the intellectual property rights of foreign right holders. In particular, China is drafting an *Anti-Monopoly Law* and is considering rules relating to the treatment of IPR by standards-setting organizations. The United States is carefully monitoring both of these efforts and has raised concerns with particular aspects of these proposals, both in bilateral meetings and at the WTO during the annual transitional reviews before the TRIPS Council and the TBT Committee.

The United States, meanwhile, has repeatedly urged China to pursue additional legislative and regulatory changes, using both bilateral meetings and the annual transitional reviews before the WTO's TRIPS Council. The focus of the United States efforts is to persuade China to improve its legal regime in certain critical areas, such as criminal IPR enforcement and legislative and regulatory reform, especially with regard to China's high criminal thresholds and other obstacles to effective enforcement. Other obstacles in the area of criminal enforcement include, for example, the lack of criminal liability for certain acts of copyright infringement, the profit motive requirement in copyright cases, the requirement of identical trademarks in counterfeiting cases, and the absence of minimum, proportional sentences and clear standards for initiation of police investigations in cases where there is a reasonable suspicion of criminal activity. At the same time, the United States has also been pressing China for a variety of changes to its administrative and civil enforcement regimes. While some of these issues do not raise specific WTO concerns, all of them will continue to detract from China's enforcement efforts until addressed.

In its 2006 Action Plan, China did not embrace reform of the *Criminal Law*, although it did undertake to "improve" its December 2004 judicial interpretation on the handling of criminal IPR cases. Improvement of that measure could include clarification of some issues related to China's problematic thresholds, but Chinese government officials have given no indication that this process will lead to the reduction or elimination of these thresholds – a key concern for U.S. right holders, particularly in light of China's obligations under Article 61 of the TRIPS

Agreement. In fact, in a series of bilateral meetings that took place in Beijing in 2006, Chinese government officials indicated that any further lowering of the thresholds below the levels set in the December 2004 judicial interpretation would require legislative action by the National People's Congress, which is not contemplated. In the United States' view, China's high thresholds for criminal prosecution help to explain why criminal remedies are so underutilized in China, as these thresholds create a substantial "safe harbor" for commercial-scale infringers. The United States is determined to resolve this problem and, in November 2006, informed China that it would be filing a formal request for WTO consultations on this issue and certain other IPR enforcement issues. However, China asked the United States to hold off on that filing so that further bilateral discussions could take place. With the support of U.S. industry, the United States agreed to hold further bilateral discussions, with the objective of seeking a resolution in the near term.

The United States has also sought improvements in China's copyright protection in the context of electronic information networks since the April 2004 JCCT meeting. China took an important step at the time of that meeting when the National Copyright Administration (NCA) issued the *Measures for Administrative Protection of Copyright on the Internet*. That measure requires Internet service providers to take remedial actions to delete contents that infringe on copyrights upon receipt of a complaint from the right holder, or face administrative penalties ranging from confiscation of illegal gains to fines of up to RMB 100,000 (\$12,500).

During the run-up to the July 2005 JCCT meeting, the United States also urged China to accede to the WIPO Internet treaties and to fully harmonize its regulations and implementing rules with them. Compliance with these treaties is not required under WTO rules, but they still reflect important international norms for providing copyright protection over the Internet. These treaties have been ratified by many developed and developing countries since they entered into force in 2002. In the case of China, this type of copyright protection is especially important in light of its rapidly increasing number of Internet users, many of whom have broadband access. At the July 2005 JCCT meeting, the United States obtained China's commitment to submit the legislative package necessary for China's accession to the WIPO Internet treaties to the National People's Congress by June 2006. Although China's fulfillment of this commitment has been delayed for technical reasons relating to coordination with Hong Kong and Macau, China did move forward with the harmonization of some of its regulations and implementing rules in 2005 and 2006. In May 2006, for example, the State Council adopted an important Internet-related measure, the *Regulations on the Protection of Copyright Over Information Networks*, which went into effect in July 2006. Overall, this measure represents a welcome step, demonstrating China's determination to improve protection of electronic data while China continues its preparations for accession to the WIPO Internet treaties. This measure is not comprehensive, however. A number of gaps remain to be filled for China to meet the challenges of Internet piracy and fully implement the WIPO Internet treaties.

With respect to software piracy, China issued new rules during the run-up to the 2006 JCCT meeting that require computers to be pre-installed with licensed operating system software and government agencies to purchase only computers satisfying this requirement. Combined with



ongoing implementation of previous JCCT commitments on software piracy, it is hoped that these rules will contribute to significant further reductions in industry losses due to software piracy, which were estimated to have declined from \$1.48 billion in 2004 to \$1.27 billion in 2005. Achieving sustained reductions in end-user software piracy will require more enforcement by China's authorities, followed by high profile publicity of fines and other remedies imposed.

In the customs area, the United States is encouraged by the Customs Administration's increased efforts to provide effective enforcement against counterfeit and pirated goods destined for export. Nevertheless, the United States remains concerned about various aspects of the *Regulations on the Customs Protection of Intellectual Property Rights*, issued by the State Council in December 2003, and the Customs Administration's May 2004 implementing rules, which were intended to improve border enforcement, make it easier for right holders to secure effective enforcement at the border and strengthen fines and punishments. Disposal of confiscated goods remains a problem under the implementing rules, which appear to mandate auction following removal of infringing features, rather than destruction of infringing goods not purchased by the right holder or used for public welfare. Allowing goods to re-enter the channels of commerce under these circumstances raises questions of consistency with provisions of the TRIPS Agreement. These rules are also problematic because they impose an unreasonably short deadline for a right holder to apply for seizure of suspected infringing goods held by the Chinese customs authorities. The United States raised these issues with China bilaterally in 2006 as well as at the WTO during the transitional review before the TRIPS Council, held in October 2006, but so far China has not indicated that it will be addressing them.

The United States also remains concerned about a variety of weaknesses in China's legal framework that do not effectively deter, and may even encourage, certain types of infringing activity, such as the "squatting" of foreign company names, designs and trademarks, the theft of trade secrets, the registration of other companies' trademarks as design patents and vice versa, the use of falsified or misleading license documents or company documentation to create the appearance of legitimacy in counterfeiting operations, and false indications of geographic origin of products. In 2006, the United States continued to discuss these and other problems with China and seek solutions for them.

In the pharmaceuticals sector, the United States continues to have a range of concerns. The United States has urged China to provide greater protection against unfair commercial use of undisclosed test and other data submitted by foreign pharmaceuticals companies seeking marketing approval for their products. The United States has also encouraged China to undertake a more robust system of patent linkage and to consider the adoption of a system of patent term restoration. In addition, built-in delays in China's marketing approval system for pharmaceuticals continues to create incentives for counterfeiting, as does China's inadequate regulatory oversight for the production of active pharmaceutical ingredients by domestic chemical manufacturers. In 2006, as in prior years, the United States sought to address all of these issues as part of its broader effort to work with China to improve China's regulatory regime for the pharmaceuticals sector.

## ***Enforcement***

The TRIPS Agreement requires China to ensure that enforcement procedures are available so as to permit effective action against any act of infringement of intellectual property rights covered by the TRIPS Agreement, including expeditious remedies to prevent infringement and remedies that constitute a deterrent to further infringement. Although the central government displayed strong leadership in modifying the full range of China's IPR laws and regulations in an effort to bring them into line with China's WTO commitments, effective IPR enforcement has not been achieved, and IPR infringement remains a serious problem throughout China. IPR enforcement is hampered by lack of coordination among Chinese government ministries and agencies, lack of training, resource constraints, lack of transparency in the enforcement process and its outcomes, and local protectionism and corruption.

Despite repeated anti-piracy campaigns in China and an increasing number of civil IPR cases in Chinese courts, overall piracy and counterfeiting levels in China remained unacceptably high in 2006. IPR infringement continued to affect products, brands and technologies from a wide range of industries, including films, music and sound recordings, publishing, business and entertainment software, pharmaceuticals, chemicals, information technology, apparel, athletic footwear, textile fabrics and floor coverings, consumer goods, food and beverages, electrical equipment, automotive parts and industrial products, among many others.

U.S. industry in 2006 continued to estimate that levels of piracy in China across all lines of copyright business range between 85 and 93 percent, indicating little or no improvement over 2005. Trade in pirated optical discs continues to thrive, supplied by both licensed and unlicensed factories and by smugglers. Small retail shops continue to be the major commercial outlets for pirated movies and music (and a variety of counterfeit goods), and roaming vendors offering cheap pirated discs continue to be visible in major cities across China. Piracy of books and journals and end-user piracy of business software also remain key concerns. In addition, Internet piracy is increasing, as is piracy over enclosed networks such as universities.

Although China made a commitment at the July 2005 JCCT meeting to take aggressive action against movie piracy, including enhanced enforcement for titles not yet authorized for distribution, right holders have monitored China's efforts and report little meaningful improvement in piracy of pre-release titles in several major cities. Meanwhile, with the assistance of the Ministry of Education, NCA took initial steps to address text book piracy on university campuses in late 2006. NCA also began to undertake campaigns to combat Internet piracy.

China's widespread counterfeiting not only harms the business interests of foreign right holders, but also includes many products that pose a direct threat to the health and safety of consumers in the United States, China and elsewhere, such as pharmaceuticals, food and beverages, batteries, auto parts, industrial equipment and toys, among many other products. At the same time, the harm from counterfeiting is not limited to right holders and consumers. China estimated its own

annual tax losses due to counterfeiting at more than \$3.2 billion back in 2002, and this figure could only have grown in the ensuing years.

The United States places the highest priority on addressing the IPR protection and enforcement problems in China, and since 2004 it has devoted significant additional staff and resources, both in Washington and in Beijing, to address these problems. A domestic Chinese business constituency is also increasingly active in promoting IPR protection and enforcement. In fact, Chinese right holders own the vast majority of design patents, utility models, trademarks and plant varieties in China and have become the principal filers of invention patents. In addition, most of the IPR enforcement efforts in China are now undertaken at the behest of Chinese right holders seeking to protect their interests. Nevertheless, it is clear that there will continue to be a need for sustained efforts from the United States and other WTO members and their industries, along with the devotion of considerable resources and political will to IPR protection and enforcement by the Chinese government, if significant improvements are to be achieved.

As in prior years, the United States worked with central and local government officials in China in 2006 in a determined and sustained effort to improve China's IPR enforcement, with a particular emphasis on the need for dramatically increased utilization of criminal remedies. A variety of U.S. agencies held regular bilateral discussions with their Chinese counterparts and have conducted numerous technical assistance programs for central and local government officials on TRIPS Agreement rules, enforcement methods and rule of law issues. In addition, the United States organized another annual roundtable meeting in China designed to bring together U.S. and Chinese government and industry officials. The United States also continued to use the IPR Working Group created at the April 2004 JCCT meeting and the JCCT process itself to press China for needed changes.

The United States' efforts have also benefitted from cooperation with other WTO members in seeking improvements in China's IPR enforcement, both on the ground in China and at the WTO during meetings of the TRIPS Council. For example, the United States, Japan and Switzerland made coordinated requests under Article 63.3 of the TRIPS Agreement in order to obtain more information about IPR infringement levels and enforcement activities in China and provide a better basis for assessing the effectiveness of China's efforts to improve IPR enforcement since China's accession to the WTO. In addition, the United States and the EC have increased coordination and information-sharing on a range of China IPR issues over the last year. China's membership in the Asia-Pacific Economic Cooperation Forum (APEC) also brings increased importance to APEC's work to develop regional IPR best practices.

The United States has also continued to pursue a comprehensive initiative to combat the enormous global trade in counterfeit and pirated goods, including exports of infringing goods from China to the United States and the rest of the world. That initiative, the Strategy Targeting Organized Piracy (STOP!), was announced in October 2004 and is a U.S. government-wide effort to stop fakes at the U.S. border, to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to expose international counterfeiters and pirates, to keep global supply chains free of infringing goods, to dismantle criminal enterprises that steal

U.S. intellectual property and to reach out to like-minded U.S. trading partners in order to build an international coalition to stop counterfeiting and piracy worldwide. China's share of infringing goods seized at the U.S. border increased from 63 percent in 2004 to 69 percent in 2005, with the total value of infringing goods from China totaling \$87.2 million. China's share of infringing goods seized at the border is more than ten times greater than that of any other U.S. trading partner.

China is making genuine efforts to improve IPR enforcement. U.S. industry has confirmed that some of China's special campaigns, such as the continuing "Mountain Eagle" campaign against trademark infringement crimes, have in fact resulted in increased arrests and seizures of infringing materials, although the disposition of seized goods and the outcomes of criminal cases remain largely obscured by lack of transparency. The 2006 Action Plan announced that China will launch more of these "special crackdown efforts" with respect to various IPR infringement problems. The United States has urged China to use its implementation of the 2006 Action Plan as an opportunity to tackle emerging enforcement challenges, particularly the sale of pirated and counterfeit goods on the Internet. In addition, the United States has suggested that China use this opportunity to examine the potential benefits of specialized national IPR courts and prosecutors, providing faster trademark examination, and ensuring that the resources available to local administrative, police, and judicial authorities charged with protecting and enforcing intellectual property rights are adequate to the task. The United States will continue to pursue these efforts in 2007.

Nevertheless, despite its many positive efforts to improve IPR enforcement, China pursues other policies that continue to impede effective enforcement. As discussed above, China refuses to make needed changes to its legal framework that would facilitate the utilization of criminal remedies. These changes should be an important objective for China, given the lack of deterrence clearly evident in China's current enforcement regime, which relies too heavily on administrative enforcement. But, China continues to maintain counter-productive measures such as its high thresholds for criminal prosecution, which continue to constrain China's enforcement authorities while creating a "safe harbor" for substantial commercial-scale infringement. At the same time, China maintains market access barriers, such as import restrictions and restrictions on wholesale and retail distribution, which discourage and delay the introduction of a number of legitimate foreign products into China's market. These barriers create additional incentives for infringement of products like movies, video games and books and inevitably lead consumers to the black market, again compounding the severe problems already faced by China's enforcement authorities.

## **Services**

The commitments that China made in the services area begin with the General Agreement on Trade in Services (GATS). The GATS provides a legal framework for addressing market access and national treatment limitations affecting trade and investment in services. It includes specific commitments by WTO members to restrict their use of those limitations and provides a forum for

further negotiations to open services markets around the world. These commitments are contained in national services schedules, similar to the national schedules for tariffs.

In its services schedule, China committed to the substantial opening of a broad range of services sectors through the elimination of many existing limitations on market access, at all levels of government, particularly in sectors of importance to the United States, such as banking, insurance, telecommunications and professional services. These commitments are far-reaching, particularly when compared to the services commitments of many other WTO members.

China also made certain “horizontal” commitments, which are commitments that apply to all sectors listed in its services schedule. The two most important of these cross-cutting commitments involve acquired rights and the licensing process. Under the acquired rights commitment, China agreed that the conditions of ownership, operation and scope of activities for a foreign company, as set out in the respective contractual or shareholder agreement or in a license establishing or authorizing the operation or supply of services by an existing foreign service supplier, will not be made more restrictive than they were on the date of China’s accession to the WTO. In other words, if a foreign company had pre-WTO accession rights that went beyond the commitments made by China in its services schedule, that company could continue to operate with those rights.

In the licensing area, prior to China’s WTO accession, foreign companies in many service sectors did not have an unqualified right to apply for a license to establish or otherwise provide services in China. They could only apply for a license if they first received an invitation from the relevant Chinese regulatory authorities, and even then the decision-making process lacked transparency and was subject to inordinate delay and discretion. In its accession agreement, China committed to licensing procedures that were streamlined, transparent and more predictable.

After five years of China’s membership in the WTO, challenges remain in securing the benefits of many of these commitments. According to a trade association with broad representation among U.S. service suppliers,

U.S. service providers have shown remarkable patience as the market opens along lines contemplated by China’s WTO accession, but slow and capricious regulatory decisions, capital requirements that far exceed prudential or other global norms, structural operating rules that encourage inefficiencies, and an incomplete separation of regulatory oversight from commercial activities make services sectors particularly troublesome from the perspective of U.S. businesses.

As in prior years, China continued to keep pace nominally with the openings required by its WTO accession agreement. It implemented market opening commitments in the banking, insurance, advertising and hospitality sectors on time or ahead of their scheduled implementation date of December 11, 2005. However, China also continued to maintain or erect terms of entry in some sectors that were so high or cumbersome as to prevent or discourage foreign suppliers

from gaining market access. For example, excessive and often discriminatory capital requirements continued to restrict market entry for foreign suppliers in many sectors, such as insurance, banking, motor vehicle financing, securities, asset management, telecommunications, construction and freight forwarding, among others. In addition, in sectors such as insurance and legal services, branching restrictions have been put into effect that call into question commitments made by China in its Services Schedule. In other sectors, particularly construction services, problematic measures appear to be taking away previously acquired market access rights.

Meanwhile, the *Administrative Licensing Law*, which took effect in July 2004, has increased transparency in the licensing process, while reducing procedural obstacles and strengthening the legal environment for domestic and foreign enterprises. As a result, the licensing process in many sectors continued to proceed in a workman-like fashion in 2006, although national treatment concerns remained, particularly in the banking and insurance sectors. In addition, in some sectors, such as direct selling and telecommunications, the licensing process was characterized by inordinate delays.

Looking forward to 2007, China is scheduled to implement several significant market-opening commitments on December 11, 2006, including in the areas of financial services, engineering and architectural services, and telecommunications services. The United States will monitor developments in these areas closely in 2007, while continuing its efforts to obtain China's full compliance with previously matured commitments.

## ***Financial Services***

### **Banking**

Prior to its accession to the WTO, China had allowed foreign banks to conduct foreign currency business in selected cities. Although China had also permitted foreign banks, on an experimental basis, to conduct domestic currency business, the experiment was limited to foreign customers in two cities.

In its WTO accession agreement, China committed to a five-year phase-in for banking services by foreign banks. Specifically, China agreed that, immediately upon its accession, it would allow U.S. and other foreign banks to conduct foreign currency business without any market access or national treatment limitations and conduct domestic currency business with foreign-invested enterprises and foreign individuals, subject to certain geographic restrictions. The ability of U.S. and other foreign banks to conduct domestic currency business with Chinese enterprises and individuals was to be phased in. Within two years after accession, foreign banks were also to be able to conduct domestic currency business with Chinese enterprises, subject to certain geographic restrictions, which were to be lifted gradually over the following three years. Within five years after accession, foreign banks are to be able to conduct domestic currency business with Chinese individuals, and all geographic restrictions will be lifted. Foreign banks

will also be permitted to provide financial leasing services at the same time that Chinese banks are permitted to do so.

As previously reported, shortly after China's accession to the WTO, the People's Bank of China (PBOC) issued regulations governing foreign-funded banks, along with implementing rules, which became effective February 1, 2002. The PBOC also issued several other related measures. Although these measures kept pace with the WTO commitments that China made, it became clear that the PBOC had decided to exercise extreme caution in opening up the banking sector. In particular, it imposed working capital requirements and other prudential rules that far exceeded international norms, both for the foreign banks' headquarters and branches, which made it more difficult for foreign banks to establish and expand their market presence in China. Many of these requirements, moreover, did not apply equally to foreign and domestic banks. For example, a foreign bank branch licensed to conduct business in all currencies for both corporate and individual clients had to satisfy an operating capital requirement of RMB 500 million (\$62.5 million), while a domestic bank branch with the same business scope needed only RMB 300 million (\$37.5 million) in operating capital. In addition, the PBOC allowed foreign-funded banks to open only one branch every 12 months.

In several bilateral meetings following China's WTO accession, the United States urged the PBOC to reconsider its prudential requirements and to bring them in line with international norms. Together with other WTO members, the United States also raised these same concerns during meetings of the WTO's Committee on Trade in Financial Services, including the transitional reviews held in 2002 and 2003. In December 2003 and July 2004, some progress took place, as the PBOC reduced working capital requirements for various categories of foreign banks. With the issuance of the *Implementing Rules for the Administrative Regulations on Foreign-Invested Financial Institutions* in July 2004, the China Banking Regulatory Commission (CBRC) also removed the restriction that had limited foreign-funded banks to opening only one new branch every 12 months. Nevertheless, the United States, along with Australia, Canada, the EC and Japan, continued to urge China to make its banking sector more accessible to foreign banks, as reflected in the transitional review before the Committee on Trade in Financial Services, held in 2004, 2005 and 2006.

Meanwhile, China kept up with its commitments regarding the lifting of geographic restrictions on foreign banks conducting domestic currency business with foreign enterprises and individuals and Chinese enterprises. In December 2004, CBRC opened up five additional cities to foreign banks, including two cities (Xian and Shenyang) one year ahead of the commitment in China's Services Schedule. In December 2005, CBRC announced the opening of seven additional cities, five more than the two cities (Shantou and Ningbo) scheduled to be phased in by that time, bringing the total to 25 Chinese cities in which foreign banks were able to conduct business.

One area in which China fell behind in its WTO commitments involves the establishment of Chinese-foreign joint banks. In the Services Schedule accompanying its WTO accession agreement, China agreed that qualified foreign financial institutions would be permitted to establish Chinese-foreign joint banks immediately after China acceded, and it did not schedule

any limitation on the percentage of foreign ownership in these banks. To date, however, China has limited the sale of equity stakes in existing state-owned banks to a single foreign investor to 20 percent, while the total equity share of all foreign investors is limited to 25 percent. The United States and other WTO members have urged China to relax these limitations during the annual transitional reviews before the Committee on Trade in Financial Services.

By September 2006, despite high capital requirements and other impediments, 191 foreign banks, including a number of U.S. banks, had branches or representative offices in China, although only major banks have been large enough to satisfy the application requirements. In addition, the business that foreign banks were most eager to pursue in China – domestic currency business – had expanded tremendously, although China’s regulatory authorities continued to shield domestic banks from foreign competition in some areas, such as by limiting product innovation by foreign banks. According to the PBOC and CBRC, the domestic currency business of U.S. and other foreign banks grew rapidly in the first two years after China’s WTO accession, even though the banks’ clients were then limited to foreign-invested enterprises and foreign individuals. Following the PBOC’s December 2003 announcement that foreign banks would be permitted to conduct domestic currency business with Chinese enterprises subject to geographic restrictions allowed by China’s WTO commitments, the growth in U.S. and other foreign banks’ domestic currency business accelerated. By September 2006, the total assets of foreign banks in China reportedly had reached \$105 billion, representing approximately 2 percent of the total banking assets in China. In some coastal cities, the amount was higher. For example, in Shanghai, foreign banks’ assets reportedly represented 12.4 percent of total banking assets in October 2005.

Notably, the five-year phase-in period for banking services by foreign banks ends on December 11, 2006. By that time, China has committed to remove remaining geographic limitations and to allow foreign banks to conduct domestic currency business with Chinese individuals. If China fully implements these commitments, as the United States has been urging China to do, U.S. and other foreign banks should benefit tremendously from new business opportunities, and China should realize important benefits from having greater access to world-class banking services.

In November 2006, however, the State Council issued the *Regulations for the Administration of Foreign-Funded Banks*. While the United States continues to work closely with U.S. banks to assess these regulations, which are intended to implement China’s December 11, 2006 commitments, these regulations have generated some immediate concerns. For example, the regulations mandate that only foreign-funded banks that have had a representative office in China for two years and that have total assets exceeding \$10 billion can apply to incorporate in China. After incorporating, moreover, these banks only become eligible to offer full domestic currency services to Chinese individuals if they can demonstrate that they have operated in China for three years and have had two consecutive years of profits. The regulations also restrict the scope of activities that can be conducted by foreign banks seeking to operate in China through branches instead of through subsidiaries. In particular, the regulations restrict the domestic currency business of foreign bank branches. While foreign bank branches can continue to take deposits from and make loans to Chinese enterprises in domestic currency, they can only take domestic



currency deposits of RMB 1 million (\$125,000) or more from Chinese individuals and cannot make any domestic currency loans to Chinese individuals. Foreign bank branches also cannot issue domestic currency credit cards to Chinese enterprises or Chinese individuals. Working closely with U.S. banks, the United States has been pressing China for changes to the regulations and will make every effort to ensure that China fully implements its commitments and that U.S. banks realize the full benefits to which they are entitled.

### Insurance

Prior to its accession to the WTO, China allowed selected foreign insurers to operate in China on a limited basis and in only two cities. Three U.S. insurers had licenses to operate, and several more were either waiting for approval of their licenses or were qualified to operate but had not yet been invited to apply for a license by China's insurance regulator, the China Insurance Regulatory Commission (CIRC).

In its WTO accession agreement, China agreed to phase out existing geographic restrictions on all types of insurance operations during the first three years after accession. It also agreed to expand the ownership rights of foreign companies. Upon accession, foreign life insurers were to be permitted to hold 50 percent equity share in a joint venture. Foreign property, casualty and other non-life insurers were to be permitted to establish as a branch or as a joint venture with 51 percent foreign equity share upon accession, and they also had to be able to establish as a wholly foreign-owned subsidiary two years after accession. In addition, foreign insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance were to be permitted 50 percent foreign equity share in a joint venture upon accession, while they had to be able to own 51 percent three years after accession and establish as a wholly foreign-owned subsidiary five years after accession. China further agreed that all foreign insurers were to be permitted to expand the scope of their activities to include health, group and pension/annuities lines of insurance within three years after accession.

China also made additional significant commitments relating specifically to branching. China scheduled a commitment to allow non-life insurance firms to establish as a branch in China upon accession and to permit internal branching in accordance with the lifting of China's geographic restrictions. China further agreed that foreign insurers already established in China that were seeking authorization to establish branches or sub-branches would not have to satisfy the requirements applicable to foreign insurers seeking a license to enter China's market.

As previously reported, CIRC issued several new insurance regulations shortly after acceding to the WTO, including ones directed at the regulation of foreign insurance companies. These regulations implemented many of China's commitments, but they also created problems in three critical areas – capitalization requirements, transparency and branching. In particular, the capitalization requirements imposed by the regulations were significantly more exacting than those of other populous countries with no less an interest in preserving a healthy insurance market, and they limited the ability of foreign insurers to make necessary joint venture arrangements. The regulations also lacked adequate transparency, as they continued to permit

considerable bureaucratic discretion and to offer limited predictability to foreign insurers seeking to operate in China's market. Meanwhile, notwithstanding several important commitments on branching, the regulations are vague on foreign insurers' branching rights, and CIRC has often been reluctant to provide clarifications.

In close consultation with U.S. insurers, the United States first raised these issues in 2002 in several bilateral meetings with CIRC, MOFTEC and the State Council and at WTO meetings, with support from Canada, the EC, Japan and Switzerland. Following high-level bilateral meetings during the run-up to the October 2002 Summit between Presidents Bush and Jiang, China began to show some flexibility. CIRC agreed to establish a working group, composed of U.S. regulators and insurers, to discuss insurance issues, with a particular focus on appropriate capitalization requirements and other prudential standards. The first meeting of the working group took place in December 2002.

Following further bilateral meetings, China issued draft implementing rules in August 2003. Although this draft demonstrated some progress with regard to capitalization requirements and transparency, more progress was needed. The United States also continued to press its concerns, particularly with regard to branching, in high-level meetings in September, October and November 2003, and at the transitional review before the Committee on Trade in Financial Services in December 2003. In May 2004, CIRC issued final implementing rules, the *Detailed Rules on the Regulations for the Administration of Foreign-Invested Insurance Companies*. These rules lowered capital requirements for national licenses from RMB 500 million (\$62.5 million) to RMB 200 million (\$25 million) and for branch offices from RMB 50 million (\$6.25 million) to RMB 20 million (\$2.5 million). These changes were welcomed by some U.S. insurers, but others still considered the capital requirements to be too high. The rules also streamlined licensing application procedures and shortened approval times, although some procedures remained unclear. Meanwhile, the rules did not adequately address branching rights, as many aspects of this area remained vague. The rules also did not address another issue that U.S. and other foreign insurers had begun to complain about – in practice, it appeared that established Chinese insurers were being granted new branch approvals on a concurrent basis, meaning more than one branch at a time, while foreign insurers had only received approvals on a consecutive basis, meaning one branch at a time. In addition, while the rules provide some guidance regarding foreign insurers wishing to apply for approval to convert from a branch to a subsidiary, CIRC has continued to have difficulty adhering to its own regulatory requirement that it act on applications within 60 days, as long delays are routine.

At the April 2004 JCCT meeting, the United States had sought and obtained a commitment from China to re-start the CIRC working group, so that U.S. regulators and insurers could discuss the range of insurance issues with CIRC officials. The United States attempted to schedule these discussions shortly after the May 2004 implementing rules were issued, but without success. Later in the year, the United States raised its concerns in the insurance area during the transitional review before the Committee on Trade in Financial Services, held in November 2004, with support from Canada and Japan. At about the same time, CIRC agreed to schedule the next working group meeting in early 2005. The CIRC working group meeting finally took

place in April 2005. It provided a useful forum for U.S. and Chinese industry experts to join U.S. and Chinese government representatives in a discussion of a broad range of concerns. Not long thereafter, at the July 2005 JCCT meeting, China agreed to make CIRC available for another working group meeting by the end of 2005. That meeting took place in December 2005, and another meeting took place in November 2006. Through those meetings and additional bilateral engagement, the United States obtained assurances from CIRC that it was China's policy to grant foreign insurers new branch approvals on a concurrent basis, as has been done for domestic insurers, but in practice it has not been happening. The United States has also obtained useful clarifications regarding the status of China's draft Insurance Law. In addition, CIRC has provided useful information regarding the *Regulations on the Administration of the Reinsurance Business*, which were issued in late 2005 without prior notice or the opportunity for public comment. However, there continues to be uncertainty about these regulations, including with regard to the issue of whether they require insurers in China to offer cessions to domestic reinsurers that would be inconsistent with China's WTO commitments.

In 2006, with all geographic restrictions having been removed by December 2004 and most business scope restrictions lifted, the operations of foreign insurers in China continued to grow. As of October 2006, 44 foreign insurers were operating in China, including a large number of U.S. insurers. Foreign insurers had only a six percent share of the national market, but they continued to capture encouraging market shares in major coastal municipalities and were working to broaden their presence in China.

In 2007, as in prior years, the United States will continue to use CIRC working group meetings and the annual transitional reviews before the Committee on Trade in Financial Services to address and resolve issues of concern to U.S. insurers, especially in the area of branching. The United States is committed to seek market access for U.S. insurers on a fair and equitable basis.

### Credit Cards

In the Services Schedule accompanying its Protocol of Accession, China committed to remove market access limitations and provide national treatment for foreign suppliers providing "payment and money transmission services, including credit, charge, and debit cards," with this commitment becoming effective with regard to the RMB business of retail clients no later than December 11, 2006. China also extended this commitment to cover the provision and transfer of financial information, financial data processing and advisory, intermediation and other financial services auxiliary to payments and money transmission services.

Under its existing rules, China restricts access to its market by foreign credit card companies. The rules only permit a bank in China to issue a credit card with a foreign logo on it if the card is co-branded with the logo of China Union Pay (CUP), an entity created by the PBOC and owned by participating Chinese banks. In addition, all RMB transactions must be processed through CUP's network, while the network of the foreign credit card company is used only to process foreign currency transactions.

In the second half of 2006, a number of troubling proposals were attributed to CUP and apparently supported by the PBOC. The common theme of these proposals was that CUP would be designated as a monopoly provider of payment and money transmission services for Chinese consumers for RMB processing, and that no other providers would be able to enter this market. Through a series of bilateral meetings beginning in September 2006, the United States cautioned China that none of the proposals being attributed to CUP would satisfy China's commitment to open up its market to foreign credit card companies. The United States reinforced this message during the transitional review before the Committee on Trade in Financial Services, held in November 2006. The United States will continue to engage China on this issue through the end of this year and, if necessary, take further appropriate actions in 2007 in an effort to ensure that U.S. credit card companies enjoy the full benefits of the market-opening commitment that China made in its WTO accession agreement.

### Motor Vehicle Financing

In its WTO accession agreement, China agreed to open up the motor vehicle financing sector to foreign non-bank financial institutions for the first time, and it did so without any limitations on market access or national treatment. These commitments became effective immediately upon China's accession to the WTO.

As previously reported, China did not open up this sector to foreign financial institutions upon its accession, leaving China's commercial banks as the only financial institutions able to offer auto loans. Despite extensive engagement by the United States and other WTO Members, it was not until October 2004, nearly three years after its accession to the WTO, that China finally implemented the measures necessary to allow foreign financial institutions to obtain licenses and begin offering auto loans.

### Financial Information Services

In its WTO accession agreement, as noted above, China committed that, for the services included in its Services Schedule, the relevant regulatory authorities would be separate from, and not accountable to, any service suppliers they regulated, with two specified exceptions. One of the services included in China's Services Schedule – and not listed as an exception – is the “provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services.”

Nevertheless, China has still not established an independent regulator in the financial information services sector. Xinhua, the Chinese state news agency, is both a major market competitor of, and the regulator of, foreign financial information service providers in China. As problems with Xinhua's regulation of this sector mounted following China's WTO accession, U.S. and other foreign financial information service providers began to call for the establishment of an independent regulator. The United States and the EC both raised concerns about this issue during the transitional review before the WTO's Committee on Trade in Financial Services, held

in September 2005. The United States continued to press China on this issue bilaterally in 2006, as did the EC.

In September 2006, a major problem developed when Xinhua issued, without an opportunity for prior public comment, the *Administrative Measures on News and Information Release by Foreign News Agencies within China*. These rules abolished the *Measures for Administering the Release of Economic Information in China by Foreign News Agencies and Their Information Subsidiaries*, which had been issued in 1996. Among other things, under the 2006 rules, Xinhua now precludes foreign providers of financial information services from contracting directly with or providing financial information services directly to domestic Chinese clients. Instead, foreign financial information service providers must operate through a Xinhua-designated agent, and the one agent designated to date is a Xinhua affiliate. These new restrictions do not apply to domestic financial information service providers and, in addition, contrast with the rights previously enjoyed by foreign information service providers since the issuance of the 1996 rules, well before China's accession to the WTO in December 2001. The United States immediately raised strong concerns with the new rules during a series of bilateral meetings in Beijing, as did the EC, as a number of potential WTO issues were implicated, including China's national treatment obligation, commitments that China made in its GATS Schedule and China's commitment to establish an independent regulator. In response to these complaints, Premier Wen publicly promised that the new rules would not change how foreign financial information service providers did business in China. Shortly thereafter, Xinhua told foreign financial information service providers that the new rules would not be applied to them until after an implementing measure was issued. The United States reiterated its concerns about these rules during the transitional review before the WTO's Committee on Trade in Financial Services in November 2006 and will continue to monitor this situation closely in 2007 in an effort to ensure that foreign financial information service providers do not face discriminatory treatment and are not subjected to new restrictions on their access to the China market.

### ***Legal Services***

Prior to its WTO accession, China had imposed various restrictions in the area of legal services. It maintained a prohibition against representative offices of foreign law firms practicing Chinese law or engaging in profit-making activities of any kind. It also imposed restrictions on foreign law firms' formal affiliation with Chinese law firms, limited foreign law firms to one representative office and maintained geographic restrictions.

China's WTO accession agreement provides that, upon China's accession to the WTO, foreign law firms may provide legal services through one profit-making representative office, which must be located in one of several designated cities in China. The foreign representative offices may act as "foreign legal consultants" who advise clients on foreign legal matters and may provide information on the impact of the Chinese legal environment, among other things. They may also maintain long-term "entrustment" relationships with Chinese law firms and instruct lawyers in the Chinese law firm as agreed between the two law firms. In addition, all quantitative and geographic limitations were to have been phased out within one year of China's

accession to the WTO, which means that foreign law firms should have been able to open more than one office anywhere in China beginning on December 11, 2002.

As previously reported, the State Council issued the *Regulations on the Administration of Foreign Law Firm Representative Offices* in December 2001, and the Ministry of Justice issued implementing rules in July 2002. While these new measures removed some market access barriers, they also generated concern among foreign law firms doing business in China. In many areas, these measures were ambiguous. For example, it appeared that these measures created an economic needs test for foreign law firms that want to establish offices in China, contrary to China's GATS commitments. These measures also seemed to take an overly restrictive view of the types of legal services that foreign law firms may provide. In addition, the procedures for establishing a new office or an additional office were unnecessarily time-consuming.

The United States has raised its concerns both bilaterally and at the WTO during the annual transitional reviews before the Council for Trade in Services, with support from the EC and Japan. To date, although a number of U.S. and other foreign law firms have been able to open a second office in China, little progress has been made on the problematic aspects of the new measures, particularly the economic needs test, the unreasonable restrictions on the types of legal services that can be provided and the unnecessary delays that must be endured when seeking to establish new offices. These obstacles continue to prevent foreign law firms from participating fully in China's legal market. The United States will continue to engage China in 2007 in an attempt to resolve these outstanding concerns.

### ***Telecommunications***

In the Services Schedule accompanying its WTO accession agreement, China committed to permit foreign suppliers to provide a broad range of telecommunications services through joint ventures with Chinese companies, including domestic and international wired services, mobile voice and data services, value-added services (such as electronic mail, voice mail and on-line information and database retrieval) and paging services. The foreign stake permitted in the joint ventures is to increase over time, reaching a maximum of 49 percent for most types of services. In addition, all geographical restrictions are to be eliminated within two to six years after China's WTO accession, depending on the particular services sector.

Importantly, China also accepted key principles from the WTO Reference Paper on regulatory principles. As a result, China became obligated to separate the regulatory and operating functions of MII (which had been both the telecommunications regulatory agency in China and the operator of China Telecom) upon its accession. China also became obligated to adopt pro-competitive regulatory principles, such as cost-based pricing and the right of interconnection, which are necessary for foreign-invested joint ventures to compete with incumbent suppliers such as China Telecom, China Netcom and China Unicom.

Five years after its accession to the WTO, China has not yet established a truly independent regulator in the telecommunications sector. The current regulator, MII, while nominally separate

from the current telecommunications operators, maintains extensive influence and control over their operations and continues to use its regulatory authority to disadvantage foreign firms.

As previously reported, the State Council issued regulations on the administration of foreign-invested telecommunications enterprises in December 2001. These regulations implemented China's commitments by providing for the establishment of foreign-invested joint ventures, and they set forth relatively clear procedures and requirements for the joint ventures when applying for approval to commence operations, although, as in several other services sectors, they also established high capital requirements (particularly for basic telecommunications services) that pose a significant barrier to entry for many potential foreign suppliers.

Another problem area developed in April 2003, when MII issued its Catalogue of Telecommunications Services. MII reclassified several telecommunications services from the value-added category to the basic category, without notice or a public comment period and contrary to widely accepted international practice. MII also placed restrictions on what new services could be classified under the value-added category. These moves have limited the ability of U.S. firms to access China's telecommunications market because, under China's Services Schedule, basic services are on a slower liberalization schedule, and MII subjects them to higher capitalization requirements. Indeed, MII requires suppliers of basic services to satisfy an excessive registered capital requirement of RMB 2 billion (\$250 million). A review of capital requirements around the world shows essentially no capital requirements in many WTO member markets, including, for example, Argentina, Australia, Brazil, Chile, the member States of the European Union, Japan and the United States. Where capital-related requirements do exist, they typically take the form of guarantees. For example, Korea requires a \$2.5 million bank guarantee or performance bond, while India requires a bank guarantee ranging from \$5 million to \$80 million, depending on geographic scope.

Overall, no meaningful progress took place in 2006 in the telecommunications services sector. Even though China has nominally kept to the agreed schedule for phasing in its WTO commitments, MII's imposition of excessive capital requirements and MII's reclassification of value-added services as basic services, together with MII's lengthy license application process, have continued to present formidable barriers to market entry for foreign enterprises. Indeed, as China nears the end of its fifth year of WTO membership, the United States is unaware of any domestic or foreign application for a license to provide basic services that has completed the MII licensing process. As a result, the number of suppliers of basic services appears to be frozen, limiting the opportunities for new joint ventures and reflecting a level of competition that is extraordinarily low given the size of China's market.

A draft of the long-awaited *Telecommunications Law* began to circulate among Chinese ministries and agencies in 2004. If China takes the initiative, this law could be a vehicle for addressing existing market access barriers and other problematic aspects of China's current telecommunications regime. In 2006, as in prior years, the United States and other WTO members have urged China to circulate the draft law for public comment, although to date China has not done so.

Over the years, the United States has raised its many concerns with China using both bilateral engagement and WTO meetings, including the annual transitional reviews before the Council for Trade in Services, where it has received support from the EC and Japan. In 2005, the United States elevated its concerns to the level of the JCCT. At the July 2005 JCCT meeting, the United States was able to persuade China to commit its telecommunications regulator, MII, to a bilateral working group to discuss capitalization requirements, resale services and other issues agreed to by the two sides. The first meeting of this working group took place in January 2006. Subsequently, the United States focused on making progress on the issue of high capital requirements during the run-up to the April 2006 JCCT meeting. At that meeting, China committed to make appropriate adjustments to its registered capital requirements for telecommunications service providers, and it was agreed by the two sides that a working group would meet to discuss China's implementation of this commitment. Since then, the United States has followed up on this commitment in the working group and in bilateral meetings with MII and MOFCOM, but China so far has made no progress toward fulfillment of this commitment. The United States will continue to press China to implement this overdue commitment through the end of this year and in 2007 as necessary.

### ***Construction and Related Engineering Services***

Upon its WTO accession, China committed to permit foreign service suppliers to supply construction and related engineering services through joint ventures with foreign majority ownership, subject to the requirement that those services only be undertaken in connection with foreign-invested construction projects and subject to registered capital requirements that were slightly different from those of Chinese enterprises. Within three years of accession, China agreed to remove those conditions, and it also agreed to allow wholly foreign-owned enterprises to supply construction and related engineering services for four specified types of construction projects.

As previously reported, in September 2002, the Ministry of Construction and MOFTEC jointly issued the *Rules on the Administration of Foreign-Invested Construction Enterprises* (known as Decree 113) and the *Rules on the Administration of Foreign-Invested Construction Engineering Design Enterprises* (known as Decree 114). These decrees provide schedules for the opening up of construction services and related construction engineering design services to joint ventures with majority foreign ownership and wholly foreign-owned enterprises. The necessary implementing rules for Decree 113 were issued in April 2003, but Decree 114 implementing rules were delayed until late 2006.

Decrees 113 and 114 created concerns for U.S. and other foreign firms by imposing new and more restrictive conditions than existed prior to China's WTO accession, when they were permitted to work in China on a project-by-project basis pursuant to Ministry of Construction rules. In particular, these decrees for the first time require foreign firms to obtain qualification certificates, effective October 2003. In addition, these decrees for the first time require foreign-invested enterprises to incorporate in China, and they impose high minimum registered capital requirements and technical personnel staff requirements that are difficult for many foreign-



invested enterprises to satisfy. In consultation with U.S. industry, the United States, in a high-level intervention, pressed its concerns about Decrees 113 and 114 and sought a delay before the decrees' problematic requirements would become effective. While Decree 114 still had no implementation date because implementing rules had not been issued, the Ministry of Construction agreed to extend the Decree 113 implementation date from October 2003 until April 2004. The United States and U.S. industry used this extension to pursue these issues further with the Ministry of Construction and MOFCOM.

In April 2004, Decree 113 went into effect. However, in September 2004, the Ministry of Construction and MOFCOM issued Circular 159, which permitted foreign providers of construction services and related construction engineering design services to continue operating on a project by-project basis until July 2005, effectively extending the effective date of the incorporation-related requirements. Since the expiration of Circular 159 in July 2005, however, U.S. and other foreign companies have faced a great deal of uncertainty when contemplating participation in projects in China.

Even though the United States and U.S. industry had sought the opportunity to comment on a draft of the implementing rules for Decree 114 for nearly four years, no draft was circulated until late October 2006, with six days being given for the submission of written comments. These implementing rules are generally positive, as they temporarily lift foreign personnel residency and staffing requirements imposed by Decree 114, and recognize the foreign qualifications of technical experts when considering initial licensing. However, they also contain restrictions that may limit market access by U.S. and other foreign companies, as they, for example, only "temporarily" lift foreign residency and personnel requirements and require two years of domestic experience for foreign companies applying for higher-level licenses. The United States has since submitted written comments on the implementing rules, which are scheduled to become effective in December 2006, and will continue to press China in 2007 to more fully open this sector to foreign competition.

Meanwhile, in November 2004, the Ministry of Construction issued a measure – the *Provisional Measures for Construction Project Management* – that restricts the provision of project management services. This measure, known as Decree 200, became effective in December 2004 and appears to preclude the same company from providing construction services and project management services on a single project. This aspect of Decree 200 raises concerns because U.S. companies often provide integrated construction services packages – combining management, design, and construction services – in project delivery systems in overseas markets. No implementing rules for Decree 200 have been issued to date.

In 2004, 2005 and 2006, the United States engaged China, both bilaterally and at the annual transitional reviews before the Council on Trade in Services, in an effort to obtain improvements in Decrees 113, 114 and 200. In addition, in November 2006, the United States was able to obtain China's agreement to hold an exchange on international best practices in the construction sector. That dialogue is tentatively scheduled to take place in May 2007. It will allow U.S. Government officials and U.S. industry representatives to explore with Ministry of Construction

officials, officials from other relevant ministries and agencies and representatives of China's construction industry how China's regulatory regime could be improved to the benefit of both the United States and China.

### ***Express Delivery Services***

The specific commitments that China made in the area of express delivery services did not require China to take implementation action upon its accession to the WTO. Basically, China agreed to increase the stake allowed by foreign express delivery companies in joint ventures over a period of years, with wholly foreign-owned subsidiaries allowed within four years of accession.

Nevertheless, as previously reported, shortly after becoming a WTO member, China issued two problematic measures. These measures required Chinese and foreign-invested international express delivery companies, including those that were already licensed by MOFTEC to provide international express delivery services (except for the delivery of private letters), to apply for and obtain so-called "entrustment" authority from China's postal authorities, China Post, their direct competitor, if they wanted to continue to provide express delivery services. The measures also placed new weight and rate restrictions on the letters that the companies could handle, in apparent contravention of China's horizontal "acquired rights" commitment (discussed at the beginning of the Services section). Working closely with U.S. express delivery companies and other affected WTO members, particularly the EC and Japan, the United States led a sustained effort that eventually convinced China to revise these measures in September and October 2002. While a streamlined entrustment application process remained in place, U.S.-invested express delivery companies were able to continue to operate without disruption, while expanding their business operations in China.

In July 2003, China began circulating draft amendments to its *Postal Law*, which generated immediate concerns among U.S. companies. Despite subsequent revisions in response to numerous interventions by the United States and other WTO members, the draft amendments circulated remained problematic on several fronts. First, the draft amendments purported to give China Post a monopoly over the delivery of letters under 500 grams, which would have constituted a new restriction on the scope of activities of existing foreign-invested express delivery companies, contrary to China's horizontal "acquired rights" commitment. Second, the draft amendments did not address the need for an independent regulator. Third, the draft amendments appeared to create a new, more burdensome licensing process to replace the existing entrustment process, and they also seemed to require express couriers to pay four percent of their revenue from the delivery of letters into a fund for universal mail service in China.

In 2004, the United States made express delivery services one of its priority issues during the run-up to the April JCCT. The United States focused its engagement with China on the weight restriction, which would cut back on the scope of activities that foreign-invested express delivery companies had been licensed to provide prior to China's WTO accession. At the JCCT meeting, Vice Premier Wu committed that old problems, like the weight restriction, would not resurface as

new problems. Three months later, in July 2004, the State Council circulated another set of draft amendments to the *Postal Law*. Despite Vice Premier Wu's commitment, these draft amendments continued to include a weight restriction, now reduced from 500 grams to 350 grams, and did little to address other U.S. concerns.

Through the remainder of 2004 and into 2005, China worked less publicly on the *Postal Law*, while the United States continued to raise its concerns in bilateral meetings and during the annual transitional reviews before the WTO's Council for Trade in Services, with support from the EC. In 2006, as more reports began to surface of problematic provisions in subsequent drafts of the *Postal Law*, the United States raised its concerns during the run-up to the April 2006 JCCT meeting. At that meeting, China reiterated its commitment that the regulatory environment for express delivery services by foreign companies would not be negatively impacted by the issuance of new rules, including the *Postal Law*. Later that year, however, China began to circulate an "eighth" draft of the *Postal Law* among some Chinese stakeholders, and this draft continued to generate serious concerns. This draft reportedly would impose a minimum weight restriction on domestic and international addressed letters weighing less than 150 grams, completely exclude foreign service providers from the domestic express delivery market and impose a tax to fund universal mail service in China. During bilateral meetings in Beijing in October 2006, the United States expressed continuing concerns and disappointment with this draft and urged China to circulate the draft for public comment. China indicated that the *Postal Law* was undergoing further revisions.

Meanwhile, in August 2006, the State Council finalized its July 2005 plan to separate China's postal operations from the administrative function of regulating China's postal system, with the State Postal Administration (SPA) to serve as the regulator and a new state-owned enterprise – the China Post Group Corporation – to be set up to conduct postal business. In September 2006, SPA announced the establishment of 31 provincial-level Postal Management Bureaus to assist in the regulatory effort, while the China Post Group Corporation is scheduled to be established in December 2006. The United States is disappointed that the State Council has not made public its July 2005 Postal Reform Plan and that the September 2006 announcement launching the provincial-level regulatory bureaus did not clarify certain of the outstanding issues, such as whether providers of express delivery services will be asked to pay into a fund to support universal mail service in China.

In 2007, the United States will continue to work closely with U.S. express delivery companies. The United States will seek to clarify China's plans for postal reform and will continue to urge China to issue a sensible and WTO-consistent set of amendments to the *Postal Law*.

### ***Aviation Services***

As previously reported, China took a significant step in July 2004 to increase market access for U.S. service providers of air transport services, an area that for the most part falls outside the scope of the GATS and is normally the subject of bilateral agreements. At that time, China signed a landmark aviation agreement with the United States that will more than double the

number of U.S. airlines operating in China and that will increase by five times the number of flights providing passenger and cargo services between the two countries over the next six years. The agreement also allows each countries' carriers to serve any city in the other country, provides for unlimited code-sharing between them, expands opportunities for charter operators, grants cargo carriers the right to provide door-to-door delivery services, and eliminates government regulation of pricing as of 2008. U.S. airlines and U.S. express delivery companies have since obtained additional routes and increased flight frequencies, as envisioned by the agreement.

Meanwhile, an important commitment enshrined in the July 2004 agreement calls for the commencement of negotiations toward further liberalization through a bilateral Open Skies Agreement. The first round of these negotiations took place in April 2006. The United States and China exchanged views and agreed to hold a second round of negotiations during the second half of 2006. However, China subsequently postponed the second round of negotiations, citing the designation of a Chinese company under Executive Order 13382, which addresses the proliferation of weapons of mass destruction. The United States will seek a resumption of these negotiations in 2007.

### *Maritime Services*

As previously reported, even though China made no WTO commitments to open up its maritime services sector, it took a significant step in December 2003 to increase market access for U.S. service providers. The United States and China signed a far-reaching, five-year bilateral maritime agreement, which gives U.S.-registered companies the legal flexibility to perform an extensive range of additional shipping and logistics activities in China. U.S. shipping and container transport services companies, along with their subsidiaries, affiliates and joint ventures, are also able to establish branch offices in China without geographic limitation.

### *Other Services*

In its accession agreement, China agreed to give foreign service suppliers increased access in several other sectors, including several types of professional services, tourism and travel-related services, educational services and environmental services. In each of these sectors, China committed to the phased elimination or reduction of various market access and national treatment limitations. To date, the United States has not discovered significant problems with China's implementation of the commitments made in these sectors, and U.S. companies confirm that the relevant laws and regulations are generally in compliance with China's WTO commitments.

In some sectors, China has actually gone beyond its commitments. For example, even though China had only committed to permit majority foreign-owned joint ventures in the convention services sector, MOFCOM opened this sector to wholly foreign-owned enterprises in February 2004.

In other sectors, however, such as audio-visual services, China has been less willing to increase market access for foreign service providers. Despite the fact that its restrictive approach encourages the illegal copying and sale of foreign films in China, China continues to treat its commitment to allow the importation of 20 foreign films per year for theatrical release on a revenue-sharing basis as a ceiling rather than a floor and further constrains the timely release of these films through distribution and marketing restrictions and lengthy film approval requirements. The United States raised these concerns with China at high levels in 2004, 2005 and 2006, including through the July 2005 and April 2006 JCCT meetings, in an attempt to obtain better, and more useful, market access for U.S. service providers. However, little progress has been made in this area.

## **Legal Framework**

In order to address major concerns raised by WTO members during its lengthy WTO accession negotiations, China committed to broad legal reforms in the areas of transparency, uniform application of laws and judicial review. Each of these reforms, if fully implemented, will strengthen the rule of law in China's economy and help to address pre-WTO accession practices that made it difficult for U.S. and other foreign companies to do business in China.

### ***Transparency***

#### Official Journal

In its WTO accession agreement, China committed to establish or designate an official journal dedicated to the publication of all laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of foreign exchange. China also committed to publish this journal on a regular basis and to make copies of all issues of this journal readily available to enterprises and individuals.

Following its accession to the WTO, China did not establish or designate an official journal. Rather, China relied on multiple channels, including ministry websites, newspapers and a variety of journals, to provide information on trade-related measures. In bilateral meetings and at the WTO, the United States urged China to adopt a single official journal, explaining that the establishment or designation of a single journal would greatly enhance the ability of WTO members to track the drafting, issuance and implementation of trade-related measures. The United States also noted that the use of a single journal to request comments on proposed trade-related measures, as envisioned in China's WTO accession agreement, would facilitate the timely notification of comment periods and submission of comments.

In early 2006, the United States elevated this issue to the level of the JCCT, pressing its concerns during the run-up to the JCCT's April 2006 meeting. In March 2006, the State Council issued a notice directing all central, provincial and local government entities to begin sending copies of all of their trade-related measures to MOFCOM for immediate publication in the *MOFCOM Gazette*. The United States has been monitoring the effectiveness of this notice, both to assess whether all government entities regularly publish their trade-related measures in the *MOFCOM Gazette* and whether all types of measures are being published. So far, adherence to the State Council's notice is far from complete.

#### Public Comment

China made a number of transparency commitments in its accession agreement. One of the most important of these commitments concerned the procedures for adopting or revising laws and regulations affecting trade in goods, services, TRIPS or the control of foreign exchange, given that China's accession to the WTO became effective while China was still in the process of revising its trade-related laws and regulations to become WTO-consistent. China agreed to

provide a reasonable period for public comment on these new or modified laws and regulations before implementing them, except in certain specific instances, enumerated in China's accession agreement. China also agreed to translate all of its trade-related laws and regulations into one or more of the WTO languages (English, French and Spanish) and to publish them in an official journal.

The principal focus of China's first year of WTO membership was on its framework of laws and regulations governing trade in goods, trade in services, IPR and trade remedies. Most of this work took place at the central government level, with more than 2,500 trade-related laws and regulations reportedly being reviewed for WTO consistency. As a result of this initial review, China reportedly repealed more than 800 laws and regulations, while it issued almost 450 new or revised ones. In 2003, the central government continued this work, issuing more than 100 new or revised laws and regulations in an effort to meet China's WTO obligations. China's 31 provinces and autonomous regions and 49 major cities also reportedly made progress, as they repealed nearly 500 trade-related measures and amended almost 200 more.

Despite the tremendous amount of work that China put into overhauling its framework of trade-related laws and regulations in 2002 and 2003, China's ministries and agencies still had a poor record of providing an opportunity for public comment *before* new or modified laws and regulations were implemented. Although the State Council issued regulations in December 2001 addressing the procedures for the formulation of administrative regulations and rules and expressly allowing public comment, many of China's ministries and agencies in 2002 continued to follow the practice prior to China's accession to the WTO, and no notable progress took place in 2003. Typically, the ministry or agency drafting a new or revised law or regulation consulted with and submitted drafts to other ministries and agencies, Chinese experts and affected Chinese companies. At times, it also consulted with select foreign companies, although it would not necessarily share drafts with them. As a result, only a small proportion of new or revised laws and regulations were issued after a period for public comment, and even in those cases the amount of time provided for public comment was generally too short.

In 2004, some improvements took place, particularly on the part of MOFCOM, which began following the rules set forth in its *Provisional Regulations on Administrative Transparency*, issued in November 2003. Those rules could potentially serve as a model for other ministries and agencies seeking to improve their transparency. Nevertheless, basic compliance with China's notice-and-comment commitment continued to be uneven, in 2004, 2005 and 2006. In the area of intellectual property rights, for example, several ministries and agencies circulated proposed measures for public comment in 2005 and 2006. The National People's Congress also circulated a proposed *Labor Contract Law* for public comment in March 2006. However, China did not provide for public comment on major trade-related laws and regulations, such as the April 2005 *Measures on the Importation of Parts for Entire Automobiles*, which has since given rise to a WTO dispute brought by the United States, the EC and Canada, CIRC's December 2005 *Regulations on the Administration of the Reinsurance Business*, the August 2006 M&A regulations, or Xinhua's September 2006 *Administrative Measures on News and Information Release by Foreign News Agencies within China*. In addition, China did not seek public input on

new rules on telecommunications value-added services issued by MII in July 2006, or new rules on qualification requirements for senior managers of insurance companies issued by CIRC in July 2006. The United States and other WTO members have also been seeking the opportunity to comment on a number of significant new measures, such as the draft *Postal Law* and the draft *Telecommunications Law*, so far without success.

Meanwhile, China's ministries and agencies continue to have a much better record when it comes to making new or revised laws and regulations available to the public. In accordance with State Council regulations issued in December 2001, which require the publication of new or amended regulations thirty days before their implementation, almost all new or revised laws and regulations have been available (in Chinese) soon after issuance and prior to their effective date, an improvement over pre-WTO accession practice. Indeed, these laws and regulations are often published not only in official journals, but also on the Internet. At the same time, however, China continues to lag behind in its obligation to provide translations of these laws and regulations.

In numerous bilateral meetings with the State Council, MOFCOM and other Chinese ministries since China's WTO accession, including high-level meetings, the United States has emphasized the importance of China's adherence to the notice-and-comment commitment in China's accession agreement, both in terms of fairness to WTO members and the benefits that would accrue to China. Together with other WTO members, the United States has also raised this issue during regular WTO meetings and as part of the annual transitional reviews conducted before various WTO councils and committees. Recently, at the April 2006 JCCT meeting, with China finally having adopted a single official journal, the United States put China on notice that the next step China needs to take is to use that journal to implement a mandatory notice-and-comment practice for all agencies proposing new or modified trade-related laws and regulations. At the same time, the United States continues to provide technical assistance to facilitate Chinese government officials' understanding of the workings, and benefits, of an open and transparent rulemaking process. In July 2006, for example, the United States put on a seminar for Chinese government officials on the operations of the Federal Register. The United States will continue to work to secure China's full compliance with this fundamental commitment in 2007.

### Enquiry Points

Another important transparency commitment requires China to establish enquiry points, where any WTO member or foreign company or individual may obtain information. As previously reported, China complied with this obligation by establishing a WTO Enquiry and Notification Center, now operated by MOFCOM's Department of WTO Affairs, in January 2002. Other ministries and agencies have also established formal or informal, subject-specific enquiry points. Since the creation of these various enquiry points, U.S. companies have generally found these various enquiry points to be responsive and helpful, and they have generally received timely replies. In addition, some ministries and agencies have created websites to provide answers to frequently asked questions as well as further guidance and information.



### ***Uniform Application of Laws***

In its WTO accession agreement, China committed, at all levels of government, to apply, implement and administer its laws, regulations and other measures relating to trade in goods and services in a uniform and impartial manner throughout China, including in special economic areas. In support of this commitment, China agreed to establish an internal review mechanism to investigate and address cases of non-uniform application of laws based on information provided by companies or individuals.

As previously reported, in China's first year of WTO membership, the central government launched an extensive campaign to inform and educate both central and local government officials and State-owned enterprise managers about WTO rules and their benefits. In addition, several provinces and municipalities established their own WTO centers, designed to supplement the central government's efforts and to position themselves so that they would be able to take full advantage of the benefits of China's WTO membership. In 2002, China also established an internal review mechanism, now overseen by MOFCOM's Department of WTO Affairs, to handle cases of non-uniform application of laws, although the actual workings of this mechanism remain unclear.

During 2006, as in prior years, some problems with uniformity persisted. These problems are discussed above in the sections on Customs and Trade Administration, Taxation, Investment and Intellectual Property Rights.

### ***Judicial Review***

In its WTO accession agreement, China agreed to establish tribunals for the review of all administrative actions relating to the implementation of laws, regulations, judicial decisions and administrative rulings on trade-related matters. These tribunals must be impartial and independent of the government authorities entrusted with the administrative enforcement in question, and their review procedures must include the right of appeal.

Beginning before China's accession to the WTO, China had taken steps to improve the quality of its judges. For example, in 1999, the Supreme People's Court began requiring judges to be appointed based on merit and educational background and experience, rather than through politics or favoritism. However, existing judges, many of whom have had no legal training, were grandfathered in. In part because of this situation, many U.S. companies in 2006 continued to express serious concern about the independence of China's judiciary. In their experience and observation, Chinese judges are often influenced by political, government or business pressures, particularly outside of China's big cities.

Meanwhile, in 2006, the United States continued to monitor how the courts designated by the Supreme People's Court's *Rules on Certain Issues Related to Hearings of International Trade Administrative Cases*, which went into effect in October 2002, have handled cases involving administrative agency decisions relating to international trade in goods or services or intellectual

property rights. So far, however, there continues to be little data, as few foreign companies have had experience with these courts.

## **APPENDIX 1**

### **List of Written Submissions Received in Response to Request for Public Comment by the Trade Policy Staff Committee on China WTO Compliance**

1. U.S.-China Business Council
2. U.S. Chamber of Commerce
3. International Intellectual Property Alliance
4. Coalition of Service Industries
5. National Association of Manufacturers
6. American Foundry Society
7. U.S. Council for International Business
8. United States Information Technology Office
9. American Seed Trade Association
10. American Iron and Steel Institute
11. Electronic Industries Alliance
12. International AntiCounterfeiting Coalition
13. American Forest & Paper Association
14. American Chemistry Council
15. Underwriters Laboratories
16. Nucor Corporation
17. U.S. Grains Council
18. ASTM International

19. Biotechnology Industry Organization
20. Committee on Pipe and Tube Imports
21. Distilled Spirits Council of the United States
22. Kason Industries
23. North American Die Casting Association
24. National Tooling & Machinery Association
25. Society of Plastics
26. Universal Electric Company
27. U.S. Wheat Associates

## **APPENDIX 2**

**List of Witnesses  
Testifying at the Public Hearing  
before the Trade Policy Staff Committee  
on China WTO Compliance  
Washington, D.C.  
September 28, 2006**

1. John Frisbie  
President  
U.S.-China Business Council
2. Myron Brilliant  
Vice President, East Asia  
U.S. Chamber of Commerce
3. Eric H. Smith  
President  
International Intellectual Property Alliance
4. Robert Vastine  
President  
Coalition of Service Industries
5. Alan Price  
On Behalf of American Iron and Steel Institute,  
Steel Manufacturers Association and  
Specialty Steel Industry of North America
6. Bill Primosch  
Senior Director, International Business Policy  
National Association of Manufacturers