

CHINA

TRADE SUMMARY

The U.S. trade deficit with China was \$162.0 billion in 2004, an increase of \$38.0 billion from \$124.1 billion in 2003. U.S. goods exports in 2004 were \$34.7 billion, up 22.4 percent from the previous year. Corresponding U.S. imports from China were \$196.7 billion, up 29.0 percent. China is currently the 5th largest export market for U.S. goods.

U.S. exports of private commercial services (i.e., excluding military and government) to China were \$5.9 billion in 2003 (latest data available), and U.S. imports were \$3.9 billion. Sales of services in China by majority U.S.-owned affiliates were \$3.4 billion in 2002 (latest data available), while sales of services in the United States by majority China-owned firms were \$125 million.

The stock of U.S. foreign direct investment (FDI) in China in 2003 was \$11.9 billion, up from \$10.5 billion in 2002. U.S. FDI in China is concentrated largely in the manufacturing, wholesale, and mining sectors.

In 2003, the United States Government observed a significant increase in bilateral trade friction, borne in part by a loss of momentum in China's WTO implementation. U.S. efforts in 2003 to reverse this trend culminated in a December meeting between President Bush and China's Premier, Wen Jiabao, at which the two leaders committed to upgrade the level of economic interaction and to undertake an intensive program of bilateral interaction with a view to resolving problems in the U.S.-China trade relationship. This new approach was exemplified by the highly constructive Joint Commission on Commerce and Trade (JCCT) meeting in April 2004, with Vice Premier Wu Yi chairing the Chinese side and Secretary of Commerce Evans and United States Trade Representative Zoellick chairing the U.S. side, and with leadership from Secretary of Agriculture Veneman on agricultural issues. At that meeting, which followed a series of frank exchanges covering a wide range of issues in late 2003 and early 2004, the two sides achieved the resolution of no fewer than seven potential disputes over China's WTO compliance.

Although U.S. stakeholders were significantly more satisfied with China's WTO performance in 2004 than in the previous two years, serious challenges remain and many U.S. businesses are still not able to maximize their opportunities in the Chinese market. Four areas continue to generate significant problems – intellectual property rights (IPR), services, agriculture and industrial policies.

In the IPR area, while China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR enforcement remains a major challenge. At the April 2004 JCCT, Vice Premier Wu Yi presented an "action plan" to address the IPR problem in China. Intended to "substantially reduce IPR infringement," this action plan calls for improved legal measures to facilitate increased criminal prosecution of IPR violations, increased enforcement

FOREIGN TRADE BARRIERS

activities and a national education campaign. The United States is monitoring implementation of this action plan closely and is scheduled to conduct an out-of-cycle review in early 2005 under the Special 301 provisions of U.S. trade law to assess China's implementation of its IPR commitments.

In the area of services, concerns in many sectors remain, largely due to transparency problems, delays in the issuance of legislative measures, and China's use of entry threshold requirements that exceed international norms. Indeed, Chinese regulatory authorities continued to frustrate efforts of U.S. providers of insurance, distribution, telecommunications and other services to achieve their full market potential in China.

In the area of agriculture, while the United States was able to make headway on some market issues, in particular biotechnology approvals and the removal of some problematic sanitary and phytosanitary barriers, a number of major concerns remain. Agricultural trade with China remains among the least transparent and predictable of the world's major markets. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities.

China has also increasingly resorted to industrial policies that limit market access by non-Chinese origin goods and that aim to extract technology and intellectual property from foreign rights-holders. The objective of these policies seems to be to support 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, or simply to protect less-competitive domestic industries.

Meanwhile, transparency concerns cut across sectors, as China's various regulatory regimes continue to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. Although China has made important strides in improving transparency across a wide range of national and provincial regulatory authorities, particularly at the Ministry of Commerce (MOFCOM), many other ministries and agencies have made less than impressive efforts to improve their transparency.

Overall, while China has a more open and competitive economy than 25 years ago, and China's WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled. In addition, some agencies and trade associations have renewed efforts to erect new technical barriers to trade. In many sectors, import barriers, opaque and inconsistently applied legal provisions, and limitations on foreign direct investment often combine to make it difficult for foreign firms to operate in China. The central government continues to implement industrial policies and protect noncompetitive or emerging sectors of the economy from foreign competition. Many provincial and lower-level governments have strongly resisted certain reforms that would eliminate sheltered markets for local enterprises or reduce

FOREIGN TRADE BARRIERS

jobs and revenues in their jurisdictions, although they have also supported market access for other foreign investors that do not pose a threat to local vested interests.

If China is to complete the implementation of its WTO commitments and institutionalize market-oriented reforms, it will need to eliminate mechanisms that allow government officials to intervene in the Chinese economy in a manner that is inconsistent with market principles. Despite its remarkable transformation over the past quarter century, China continues to suffer from its command economy legacy. As a result, Chinese economic policy-making often operates in a way that prevents U.S. businesses from achieving their full potential in the China market. China also needs to permit greater market access, especially in the services sector, in the ongoing Doha Development Agenda trade negotiations at the WTO.

IMPORT REGULATION

China has traditionally restricted imports through high tariffs and taxes, quotas and other non-tariff measures, and restrictions on trading rights. In 2002, as part of its first year in the WTO, China significantly reduced tariff rates on many products and the number of goods subject to import quotas, expanded trading rights for Chinese enterprises, and increased the transparency of its licensing procedures. However, during 2003, China's second year of WTO membership, while China continued to reduce tariff rates on schedule and made other implementation progress, bureaucratic inertia and a desire to protect sensitive industries contributed to a significant loss of the momentum created in the first year of China's WTO membership. In 2004, China made progress by implementing required tariff reductions on schedule, including those related to China's continued participation in the Information Technology Agreement, and by fully implementing its trading rights commitments in July, nearly six months ahead of schedule.

Trading Rights

Prior to its WTO accession, China restricted the types and numbers of entities with the right to trade. Only those domestic and foreign firms with trading rights could import goods into, or export goods out of, China. Restrictions on the type and number of firms with trading rights contribute to systemic inefficiencies in China's trading rights system and create substantial incentives to engage in smuggling and other corrupt practices.

Liberalization of China's trading rights system had been proceeding gradually since 1995. The pace accelerated in 1999 when MOFCOM's predecessor, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), announced new guidelines allowing a wide variety of Chinese firms with annual export volumes valued in excess of \$10 million to register for trading rights. In August 2001, China extended this regulation to allow foreign-invested firms to export their finished products. Import rights of foreign-invested firms were still restricted to the importation of inputs, equipment and other materials directly related to their manufacturing or processing operations. Firms and individuals without trading rights, including foreign-invested

FOREIGN TRADE BARRIERS

firms with a manufacturing presence in China seeking to import products made outside of China, were required to use a local agent.

In its WTO accession agreement, China committed to substantial liberalization in the area of trading rights. Specifically, China committed to eliminate its system of examination and approval of trading rights and to make full trading rights automatically available to 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, which was the same deadline for China to eliminate most restrictions in the area of distribution services. China further committed to expand the availability of trading rights pursuant to an agreed schedule during the first three years of its WTO membership.

Through the first two years of its WTO membership, China fully implemented the required liberalization of trading rights for Chinese enterprises. However, China did not meet the December 11, 2003 deadline to grant full trading rights to all joint ventures with foreign ownership. Instead, China continued to limit the availability of trading rights for these enterprises by imposing eligibility conditions, including requirements related to minimum registered capital, import levels, export levels and prior experience.

In January 2004, China circulated a draft of a new Foreign Trade Law for comment. This draft included provisions intended to institute an automatic trading rights system and bring China into full compliance with its WTO commitments on trading rights for all Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals. With certain modifications requested by the United States, the new Foreign Trade Law took effect on July 1, 2004. It allows all individuals and organizations with business licenses, following registration, to import and export goods and technologies, except for those forbidden by the government or reserved for state trading.

In December 2004, in accordance with the schedule set forth in its WTO accession agreement, China also ended its practice of granting import rights or export rights for certain products – steel, natural rubber, wools, acrylic and plywood – only to designated enterprises. These products can now be traded by any domestic or foreign enterprise or individual.

Under the terms of China's WTO accession, the importation of some goods, such as grains, cotton, vegetable oils, petroleum, sugar, fertilizers, news publications and related products, can still be reserved primarily for state trading enterprises. However, for grains, cotton, vegetable oils and fertilizers, China committed to make a portion of the tariff-rate quotas (ranging from 10 percent to 90 percent) available for importation through non-state traders. In some cases, the percentage available to non-state traders increases annually for a set number of years.

FOREIGN TRADE BARRIERS

Import Substitution Policies

Throughout the 1990s, China gradually reduced formal import substitution policies. In its WTO accession agreement, China committed that it would not condition import or investment approvals on whether there are competing domestic suppliers or impose other performance requirements. In anticipation of this commitment, China enacted legal changes in 2000 and 2001 to eliminate local content requirements for foreign investments. Under the prevailing rules, however, investors are still “encouraged” to follow some of the formerly mandated practices. Instances in which the Chinese Government has reportedly pursued import substitution or similar policies include:

Semiconductors

China’s 10th Five-Year Plan calls for an increase in Chinese semiconductor output from \$2 billion in 2000 to \$24 billion in 2010. In pursuit of this policy, China has attempted to encourage the development of China’s domestic integrated circuit (IC) industry through, among other things, discriminatory VAT policies. In particular, through a series of measures, China has provided for the rebate of a substantial portion of the 17 percent VAT paid by domestic manufacturers on their locally produced ICs. China, meanwhile, charged the full 17 percent VAT on imported ICs, unless they were designed in China. After bilateral meetings on this issue failed to yield a change in China’s policy, in March 2004, the United States filed the first and to date only WTO case against China. In the ensuing consultations, China signaled its willingness to discuss a possible resolution. In July 2004, the United States and China reached a settlement in which China agreed to immediately cease certifying new Chinese IC manufacturers or products as eligible for the VAT rebate and to issue the necessary regulations to eliminate the VAT rebate entirely by November 1, 2004, with an effective date no later than April 1, 2005. China also agreed to repeal the relevant implementing rules that had made VAT rebates available for ICs designed in China but manufactured abroad by September 1, 2004, with an effective date no later than October 1, 2004. China issued the promised measures in September and October 2004.

Fertilizer

In 2001, China began exempting all phosphate fertilizers except diammonium phosphate (DAP) from the VAT. DAP, a product that the United States exports to China, competes with other phosphate fertilizers produced in China, particularly monoammonium phosphate. U.S. producers have complained that China has employed its VAT policies to benefit domestic fertilizer production.

Automobile Investment Guidelines

China’s automobile industrial policy offered significant advantages for foreign-invested factories using high-levels of local content. In 2001, in anticipation of China’s new obligations as a WTO

FOREIGN TRADE BARRIERS

Member, the State Economic and Trade Commission (SETC) issued Bulletin No.13, which provided that the preferential policy for automobile localization rates would be cancelled upon China's WTO accession. However, U.S. auto manufacturers reported that some local government officials continued to require local content and cited the old automobile industrial policy's standards. China also committed to issue a revised automotive industrial policy within two years of its WTO accession, or by December 11, 2003, but missed this deadline. In mid-2003, China began circulating a draft of a new automobile industrial policy for review by select domestic enterprises. Foreign automakers later obtained copies from their joint venture partners, but the U.S. Government's request for a copy was refused. In May 2004, China issued the final version of its new automobile industrial policy. This version had been revised to eliminate an earlier controversial 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. It also included a number of vague provisions, such as in the area of complete knocked-down auto kits, whose implementation will warrant close scrutiny.

Telecommunications Equipment

There have been continuing reports of Ministry of Information Industry (MII) and China Telecom adopting policies to discourage the use of imported components or equipment. For example, MII has reportedly still not rescinded an internal circular issued in 1998 instructing telecommunications companies to buy components and equipment from domestic sources.

Tariffs and Other Import Charges

Under the terms of its WTO accession, China committed to substantial annual reductions in its tariff rates, with most of them taking place within five years of China's WTO accession. The largest reductions took place in 2002, immediately after China acceded to the WTO, when the overall average tariff rate fell from over 15 percent to 12 percent.

China's post-WTO accession tariff rates are "bound," meaning that China cannot raise them above the bound rates without "compensating" WTO trading partners, i.e., re-balancing tariff concessions or, in accordance with WTO rules, being subject to withdrawal of substantially equivalent concessions by other WTO members. "Bound" rates give importers a more predictable environment. China may also apply tariff rates significantly lower than the WTO-required rate, as in the case of goods that the government has identified as necessary to the development of a key industry. For example, China's Customs Administration has occasionally announced preferential tariff rates for items that benefit key economic sectors, in particular for the automotive, steel and chemical industries.

China's WTO accession commitments are having a dramatic effect on tariffs for many products of interest to the United States. Tariffs for some passenger cars were over 100 percent prior to accession, and will be reduced to 25 percent by July 1, 2006. China will also reduce its tariffs on

FOREIGN TRADE BARRIERS

auto parts from about 17 percent to 9.5 percent by July 1, 2006. China's elimination of tariffs on the products covered by the Information Technology Agreement (ITA) – semiconductors and semiconductor manufacturing equipment, computers and computer parts, software, telecommunications equipment and computer-based analytical instruments – began upon accession and is scheduled to be completed by January 1, 2005. U.S. exports of ITA goods to China continued to expand in 2004, increasing by 45 percent from January through September 2004, compared to the same period in 2003, and were projected to exceed \$6 billion by the end of 2004.

China also continued its timely implementation of another significant tariff initiative, which involves chemicals. China continued to make the required tariff reductions on more than two-thirds of the 1,100-plus products covered by the WTO's Chemical Tariff Harmonization Agreement in 2004, with continuing significant results. U.S. chemical exports covered by this agreement increased by 36 percent from January through September 2004, and were projected to exceed \$5.3 billion by the end of the year, well above 2003's healthy total of \$3.9 billion.

A number of other industrial products benefiting from reduced tariffs showed strong growth in 2004. For example, U.S. machinery exports, including products such as machine tools, gas turbines and compressors for refrigeration machines, increased by 42 percent from January through September 2004, with a projected year-end total of \$6.5 billion. U.S. medical and optical equipment exports increased by 34 percent from January through September 2004, with a projected year-end total of \$2.1 billion.

Meanwhile, by January 1, 2004, tariffs for U.S. priority agricultural products had fallen from an average of 31 percent to 14 percent. The tariff reductions made by China contributed to a marked increase in certain U.S. exports to China in 2004, some of which were also aided by increased demand. Exports of some bulk agricultural commodities increased dramatically, particularly cotton exports (which totaled \$1.3 billion during the period from January through September 2004, representing a 270 percent increase over the record level for the same period in 2003) and wheat exports (which totaled \$414 million during the period from January through September 2004, representing an increase of nearly 1,600 percent over the same period in 2003). U.S. soybean exports continued to perform strongly, having more than doubled since China's WTO accession (despite declining from \$1.2 billion for the period from January through September of 2003 to \$929 million for the same period in 2004). Exports of consumer-oriented agricultural products increased by 20 percent from January through September 2004, when compared to the same period in 2003, and were projected to reach \$526 million by the end of the year. Exports of forest products such as lumber also performed strongly, increasing by nearly 60 percent for the first nine months of 2004, with a projected year-end total exceeding \$400 million. Meanwhile, fish and seafood exports, after having increased from \$119 million in 2001 to \$135 million in 2002, and then to \$176 million in 2003, rose by another 55 percent in the first nine months of 2004 and were projected to reach \$274 million by the end of the year.

FOREIGN TRADE BARRIERS

However, China plans to maintain high duties on some products that compete with sensitive domestic industries. For example, the tariff on large motorcycles will only fall from 60 percent to 45 percent. Likewise, most video, digital video and audio recorders and players still face duties of around 30 percent. Raisins face duties of 35 percent.

Tariff Classification

Chinese customs officers have wide discretion in classifying a particular import. While foreign businesses might at times have benefited from their ability to negotiate tariff classification into tariff categories with lower import duty rates, lack of uniformity makes it difficult to anticipate border charges.

At the end of 2004, the National Development and Reform Commission (NDRC) was in the process of drafting the Administrative Measures for the Import of Automobile Components Fulfilling the Characteristics of a Whole Vehicle. The United States is closely monitoring the drafting process to determine whether any changes in tariff classifications for key automobile components are being contemplated.

Customs Valuation

Importers have often reported inappropriate valuation methods by customs officials, resulting in higher-than-necessary customs charges. In early 2002, China released new valuation regulations in order to bring its valuation practices into conformity with the WTO Customs Valuation Agreement.

Despite the issuance of the new valuation regulations, importers report that many Customs officials continue to use “reference price” lists rather than the actual transaction price for valuation purposes. While at times this can result in lower import charges, it often results in a higher dutiable value. China did make efforts to eliminate the practice of using reference pricing in 2004. Nevertheless, this practice continues to be found at many ports.

In addition, many Customs officials still automatically apply royalty and software fees to the dutiable value, even though China’s new regulations correctly direct them to add those fees only if they are import-related and a condition of sale of the goods being valued. By the end of the year, although some improvement appears to have taken place, the new regulations have not led to uniform, WTO-consistent implementation by China’s customs officials in this area.

Pursuant of the terms of its WTO accession, China committed to begin applying the WTO Decision on Valuation of Carrier Media Bearing Software for Data Processing Equipment by December 11, 2003. That decision makes clear that duties are to be assessed on the basis of the value of the underlying carrier medium, meaning, for example, the floppy disk or CD-ROM itself, rather than on the imputed value of the content, which includes the data recorded on a floppy disk or CD-ROM. In December 2003, following high-level bilateral engagement, China

issued final regulations implementing the WTO decision and began charging duties based on the value of the underlying carrier medium. In 2004, some U.S. exporters reported that China's implementation of these regulations has been uneven and that the treatment of particular products varies from one Customs Administration office to another.

U.S. exporters also complained in 2004 about the Customs Administration's handling of a similar issue. With regard to 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 on the imports based on the estimated value of the yet-to-be-produced copies. The United States has urged China to follow the same principle that applies to carrier media bearing software and assess duties based on the value of the underlying carrier medium.

Rules of Origin

In 2004, China was still operating under regulations issued in the 1980s for the purpose of determining origin for import and export purposes. Nevertheless, even though China's Customs Administration was slow in drafting new regulations, importers did not report problems stemming from inappropriate application of rules of origin. With the issuance of the Regulations on the Origin of Imported and Exported Goods in August 2004 and the Rules on the Substantial Transformation Criteria under the Non-Preferential Rules of Origin in December 2004, China finally issued the measures intended to ensure that China's rules of origin for import and export purposes conform with WTO rules. These measures, which were not circulated in advance for public comment, were scheduled to take effect on January 1, 2005.

Border Trade

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. Nonetheless, it appears large operators are still able to take advantage of border trade policies to import bulk shipments across China's land borders into its interior at preferential rates. In addition, China continues to use border trade policies to provide preferential treatment for Russian timber imports, to the detriment of U.S. timber exporters.

Antidumping, Countervailing Duty and Safeguard Measures

Since acceding to the WTO, China has emerged as a significant user of antidumping (AD) measures, with a total of 59 antidumping measures covering 18 countries currently in place and 35 ongoing AD investigations in progress. China continued to actively apply its antidumping law in 2004, initiating several new investigations, five of which involved U.S. exports.

FOREIGN TRADE BARRIERS

Chemical products remain the most frequent target of Chinese antidumping actions.

Most of the rules and regulations used by MOFCOM to conduct its AD investigations were issued as provisional measures by MOFCOM's predecessor agencies – MOFTEC and the State Economic and Trade Commission – shortly after China acceded to the WTO. While these measures generally represent good-faith efforts to implement the relevant WTO commitments and to improve China's pre-WTO accession measures, they also contain vague language, have gaps in areas of practice and allow inordinate discretion. Meanwhile, China's handling of AD investigations and reviews continues to raise concerns in key areas such as transparency and due process. Concerns with transparency, including access to information, are especially acute with regard to the injury portion of investigations. The United States is seeking to clarify and address these concerns both bilaterally and multilaterally.

To date, China has not initiated a countervailing duty investigation. China's only safeguard measure was removed at the end of 2003 after being in place for less than two years.

The Supreme People's Court has issued a judicial interpretation covering the review of AD and other trade remedy decisions. To date, however, judicial review of these types of decisions remains untested.

Non-Tariff Barriers

China's WTO accession agreement obligated China to address many of the non-tariff barriers it had historically used to restrict trade. For example, China is obligated to phase out its import quota system, apply international norms to its testing and standards administration, remove local content requirements, and make its licensing and registration regimes transparent. At the national level, China made progress following its WTO accession in reforming its testing system, revising regulations requiring local content, and improving overall regulatory transparency, including in the licensing area. Despite this progress, however, as China's trade liberalization efforts moved forward, some non-tariff barriers remained in place and even increased in 2004.

Three years after China's WTO accession, many U.S. industries complain that they face significant non-tariff barriers to trade, which are discussed in more detail in various sections below. These barriers include, for example, regulations that set high thresholds for entry into service sectors such as banking and insurance, selective and unwarranted inspection requirements for agricultural imports and the use of questionable sanitary and phytosanitary measures to control import volumes. Many U.S. industries have also complained about China's manipulation of technical regulations and standards to favor domestic industries.

Import Quotas

In the past, China often did not announce quota amounts or the process for allocating quotas. The government set quotas through negotiations between central and local government officials

FOREIGN TRADE BARRIERS

at the end of each year. Quotas on most products were eliminated or scheduled to be phased out under the terms of China's WTO accession. China's accession agreement required China to eliminate existing quotas for the top U.S. priority products upon accession and phase out remaining quotas, generally by two years but no later than five years after accession. On January 1, 2004, China eliminated import quotas on crude oil, refined oil, natural rubber and tires, in accordance with the schedule set forth in its WTO accession agreement. In prior years, China had eliminated import quotas on other products on schedule (such as air conditioners, sound and video recording apparatus, color TVs, cameras and watches) or ahead of schedule (crane lorries and chassis and motorcycles). When the auto quotas officially end on January 1, 2005, China will no longer have any import quotas in place.

Tariff-Rate Quotas

In 1996, China claimed to have introduced a tariff-rate quota (TRQ) system for imports of wheat, corn, rice, soy oil, cotton, barley, and vegetable oils. The quota amounts were not publicly announced, application and allocation procedures were not transparent, and importation occurred through state trading enterprises. China later introduced a TRQ system for fertilizer imports. Under these TRQ systems, China places quantitative restrictions on the amount of these commodities that can enter at a low "in-quota" tariff rate; any imports over that quantity are charged a prohibitively high duty.

As part of its WTO accession commitments, China was to establish large and increasing TRQs for imports of wheat, corn, rice, cotton, wool, sugar, vegetable oils, and fertilizer, with most in-quota duties ranging from 1 percent to 9 percent. Each year, a portion of each TRQ is to be reserved for importation through non-state trading entities. China's accession agreement sets forth specific rules for administration of the TRQs, including increased transparency and reallocation of unused quota to end-users that have an interest in importing.

However, China's implementation of its TRQ systems has been problematic since it joined the WTO. Regulations for the administration of the TRQ systems were issued late, did not provide the required transparency and imposed burdensome licensing procedures. TRQ allocations in 2002 were also plagued by delays. Chinese officials repeatedly argued that the agencies responsible for TRQ administration were unprepared for such a difficult task, resulting in one-time delays in allocations. China's performance improved in certain respects during 2002, and 2003 TRQs were issued close to the prescribed times. However, the most serious problems – lack of transparency, sub-divisions of the TRQ, small allocation sizes and burdensome licensing procedures – persisted in 2003.

In June 2003, following high-level meetings between the United States and China, China agreed to take steps to address most of these concerns as they related to agricultural commodities. China followed through in part in October 2003, when NDRC issued new regulations for shipments beginning January 1, 2004. Key changes made by these regulations included the elimination of separate allocations for general trade and processing trade, the elimination of

FOREIGN TRADE BARRIERS

certain unnecessary licensing requirements, and the creation of a new mechanism for identifying allocation recipients. In 2004, 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 continued to be problematic, although some improvement did take place for some of the commodities subject to TRQs. In addition, 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 lingering concerns with NDRC's handling of the cotton TRQs, U.S. cotton exports totaled \$1.3 billion during the period from January through September 2004, representing a 270 percent increase over the record level for the same period in 2003. In addition, U.S. wheat exports totaled \$414 million during the period from January through September 2004, representing an increase of nearly 1,600 percent over the same period in 2003.

Meanwhile, the administration of China's TRQ system for fertilizer, handled by SETC and subsequently MOFCOM, has begun to improve, and U.S. exporters have made inroads into China's market. However, U.S. exporters continue to complain about a lack of transparency and the inconsistent interpretation of the relevant regulations by provincial government authorities.

Import Licenses

In the early 1990s, China began to reduce substantially the number of products subject to import licensing requirements. With its WTO accession in December 2001, China committed to the fair and non-discriminatory application of licensing procedures. Among other things, China also committed upon its WTO accession to limit the information that a trader must provide in order to receive a license, to ensure that licenses are not unnecessarily burdensome, and to increase transparency and predictability in the licensing process.

MOFTEC issued new regulations and implementing rules to facilitate licensing procedures shortly after China's accession to the WTO. However, license applicants initially reported that they have had to provide sensitive business details unnecessary for simple import monitoring. In some sectors, importers also reported that MOFTEC was using a "one-license-per-shipment" system rather than providing licenses to firms for multiple shipments. This system acted as an impediment to trade. MOFTEC began to allow more than one shipment per license in late 2002 following U.S. interventions, although the measure authorizing the "one-license-per-shipment" system apparently remains in place.

China's inspection and quarantine agency, the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ), has also imposed inspection-related requirements that have led to restrictions on imports of some U.S. agricultural goods. In particular, two AQSIQ measures issued in 2002 require importers to obtain an import inspection permit or a quarantine permit for many agricultural goods, such as livestock, poultry, grains, oilseeds, planting seeds, horticultural products, and hides and skins, before they can enter China. U.S. exporters have

FOREIGN TRADE BARRIERS

expressed concern that AQSIQ is using the procedures provided for by these measures to control the pace and quantity of some imports, which would be contrary to China's market access and import licensing commitments. They have also been concerned about the burdensome nature of these procedures and reported selective enforcement by AQSIQ.

Following multiple U.S. interventions, some progress appeared to have been achieved in early 2003, as China discontinued arbitrary limits on imported poultry and pork shipments. However, many U.S. concerns have not yet been addressed. In 2004, China made more progress. AQSIQ issued a new decree in June 2004, known as Decree 73, which made quarantine inspection permits for animal and plant products more workable by extending their validity period from three to six months and thereby providing importers with a longer window of opportunity to purchase, transport and discharge their cargoes before their permits expire. In August 2004, China also issued an announcement that appears to exempt 15 categories of animal and plant products from the requirement to obtain quarantine inspection permits in advance of entry and prior to signing an import contract.

While both of the developments in 2004 were positive, Decree 73 raised some new concerns with regard to required contract terms and commercial risk. In an environment where AQSIQ has changed regulations with little or no warning, many U.S. shippers complained that Decree 73 increased the financial risk for exporters shipping commodities to China. China repeatedly assured the United States that Decree 73 was not intended to introduce any new requirements and that U.S. soybean exports, in particular, would not be affected by it. As 2004 was drawing to an end, it appeared that Decree 73 may have created uncertainty about China's presence as a purchaser in the soybean market and contributed to general downward pressure on world soybean prices. Nevertheless, U.S. soybean exports to China continued to go forward, and trade in the other grains and feeds affected by Decree 73 did not appear to have been negatively impacted.

INTERNAL POLICIES

Taxation

In April 2001, the National People's Congress Standing Committee passed long-awaited changes to the tax collection law, designed to standardize and increase the transparency of China's tax procedures. The State Council issued detailed regulations for the implementation of this law in September 2002. As part of a broader campaign to "rectify market order" and eliminate inter-provincial barriers to domestic commerce, the Chinese central government also implemented measures to prevent local governments from applying tax treatment that discriminated in favor of locally owned firms.

In order to narrow the widening urban-rural income gap, the Central Committee of the Communist Party of China and the State Council issued Document No. 1 of 2004, which instructed the governments at all levels to reduce the agricultural tax rate of 8.4 percent by 1

FOREIGN TRADE BARRIERS

percent in 2004, along with the removal of all taxes on special farm produce except for tobacco. Document No. 1 also calls for further reductions in the agricultural tax rate until it is totally eliminated within five years. Where fiscally feasible, governments were also called upon to reduce or eliminate agricultural taxes more quickly. By the end of 2004, 22 of China's 31 provincial-level governments had eliminated agricultural taxes.

Foreign investors, including those who have used investment as an entry point to the Chinese domestic market, have benefited from investment incentives, such as tax holidays and grace periods, which allow them to reduce substantially their tax burden. Domestic enterprises have long resented rebates and other tax benefits enjoyed by foreign-invested firms, and these benefits may be gradually phased out.

Application of China's single most important revenue source – the VAT, which ranges between 13 percent and 17 percent, depending on the product – is uneven. Importers from a wide range of sectors report that, because taxes on imported goods are reliably collected at the border, they are sometimes subject to application of a VAT that their domestic competitors often fail to pay. As discussed above (in the section on Import Substitution Policies), the United States was successful in obtaining China's agreement to remove discriminatory VAT policies favoring domestically produced semiconductors. China's selective exemption of certain fertilizer products from the VAT has also operated to the disadvantage of imports from the United States. In addition, China retains an active VAT rebate program for exports, although rebate payments are often delayed. In 2003, China announced the reduction of VAT rebates for exports by three percentage points partly in response to foreign complaints about an under-valued RMB. Although State Administration of Taxation officials plan eventually to eliminate rebates in order to increase tax revenues, China has continued this practice in order to spur domestic economic growth. In December 2004, for example, the Ministry of Finance (MOF) and the State Administration of Taxation issued a circular announcing an increase in the VAT rebate rate from 13 percent to 17 percent for the export of certain IT products, including integrated circuits, independent components, mobile telecommunication equipment and terminals, computers and periphery equipment, and numerical-controlled machine tools.

China's 1993 consumption tax system continues to raise concerns among U.S. exporters. Because China uses a substantially different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on imported consumer goods ranging from alcoholic beverages to cosmetics to automobiles is higher than for competing domestic products.

Standards, Technical Regulations and Conformity Assessment Procedures

In its WTO accession agreement, China committed that it would ensure that its regulatory authorities apply the same standards, technical regulations 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. China also committed that, in order to eliminate unnecessary barriers to trade, it would not maintain multiple or duplicative

FOREIGN TRADE BARRIERS

conformity assessment procedures and would not impose requirements exclusively on imported products. China further committed to ensure that its standards developers, regulatory authorities and conformity assessment bodies operated with transparency and allowed reasonable opportunities for public comment on proposed standards, technical regulations and conformity assessment procedures.

In anticipation of these commitments, China devoted significant energy to reforming its standards and testing and certification regimes prior to its WTO entry. In April 2001, China merged its domestic standards and conformity assessment agency and entry-exit inspection and quarantine agency into one new organization, AQSIQ. Chinese officials explained that this merger was designed to eliminate discriminatory treatment of imports, including requirements for multiple testing simply because a product was imported rather than domestically produced. China also formed two quasi-independent agencies administratively under AQSIQ: the Certification and Accreditation Administration of China (CNCA), charged with the task of unifying the country's conformity assessment regime, and Standardization Administration of China (SAC), responsible for setting mandatory national standards and unifying China's administration of product standards and aligning its standards and technical regulations with international practices and China's commitments under the WTO Agreement on Technical Barriers to Trade.

Since AQSIQ's issuance of rules in January 2002 to facilitate its adoption of international standards, China has made significant progress toward its goal of having 70 percent of its nearly 20,000 technical regulations based on international standards within 5 years of its accession to the WTO. Nevertheless, in a number of sectors, including autos, auto parts, telecommunications equipment, wireless local area networks (see the "WAPI" section below), radio frequency identification tag technology, audio-video coding, whiskey and other distilled spirits, concern has grown as China has pursued the development of unique technical requirements, despite the existence of well-established international standards. These China-specific standards, which sometimes appear to lack a sound basis, could create significant barriers to entry into China's markets because of the high cost of compliance for foreign companies.

The lack of transparency in China's standards development process also troubles many foreign companies. The vast majority of standards-setting bodies are not fully open to foreign participation, in some cases refusing membership to foreign firms and in other cases refusing to allow companies with majority foreign ownership to vote. In some cases, foreign firms are allowed non-voting observer status, but are required to pay membership fees far in excess of those paid by the voting members.

Despite China's commitment to apply the same standards and fees to domestic and imported products upon its accession to the WTO, many U.S. industries have complained about China's manipulation of technical regulations and standards to favor domestic industries. In fact, SAC issued a strategy report in September 2004 promoting China's development of standards and technical regulations as a means of protecting domestic industry as tariff rates fall. At the sub-

FOREIGN TRADE BARRIERS

national level, importers have expressed concern that local officials do not understand China's WTO commitments and apply arbitrary technical regulations and standards to protect local industries. These problems are compounded by the fact that coordination between AQSIQ and its new affiliated bodies, CNCA and SAC, is lacking, as is coordination between these bodies and China Customs and other ministries and agencies, at both the central and local government levels, with responsibilities relating to technical regulations and standards.

Meanwhile, some importers report discriminatory treatment and uneven enforcement of technical regulations and standards. For example, foreign companies' products can only be tested at certain laboratories. Limited testing and certification capacity means that evaluations sometimes take much longer than international best practice would suggest appropriate. As testing and certification capacity expands to meet this demand, U.S. companies with multi-country operations worry that inexperienced laboratories might make negative determinations that would have global consequences for the company. Meanwhile, redundant testing requirements continue to trouble U.S. companies, particularly in cosmetics, new chemicals, pharmaceuticals, medical equipment, cellular telephones and other telecommunications products and consumer electronic products. In December 2004, SAC created technical committees to develop standards for testing environmental equipment, genetically modified organisms, and new plant and animal varieties, suggesting that foreign companies may soon see additional requirements in these industries as well.

U.S. companies also cite problems with a lack of transparency in the certification process, lack of coordination among standards bodies, burdensome requirements and long processing times for licenses. Some companies have also expressed concern that their intellectual property will be released to competitors when they submit samples of high-technology products for mandatory quality testing. Technical committees that evaluate products for licensing and certification are generally drawn from a pool of government, academic and industrial experts that companies fear may be too closely associated with their competitors. In some cases, laboratories responsible for testing imported products are affiliated with domestic competitors, making the possibility of intellectual property being released more likely.

China's designated standards notification authority, MOFCOM, has been notifying proposed technical regulations and conformity assessment procedures to WTO members, as required by the WTO Agreement on Technical Barriers to Trade (TBT Agreement). Almost all of these notified measures have emanated from AQSIQ or SAC, however, and generally have not included measures drafted by other agencies. Lack of meaningful comment periods is also an issue. In many other cases, Chinese regulatory authorities provided insufficient time to consider interested parties' comments before a regulation was adopted.

In 2004, SAC sought to achieve tighter interagency coordination for a wide-ranging review of existing standards, and increased China's participation in international standards development organizations. SAC also issued two strategy reports discussing the importance of transparency and interagency coordination in the development of technical regulations and standards. These

FOREIGN TRADE BARRIERS

reports also allude to the use of technical regulations and standards in order to minimize royalty payments to foreign intellectual property holders, encourage technology transfer on terms favorable to Chinese companies, and enhance national prestige.

WAPI

A particularly significant example of China's development of unique technical requirements, despite the existence of well-established international standards, 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 scheduled to become fully effective in June 2004, incorporated the WLAN Authentication and Privacy Infrastructure (WAPI) encryption technique for secure communications. This component of the standards differed significantly from internationally recognized standards. China sought to enforce the use of WAPI by providing the necessary algorithms only to a limited number of Chinese companies. U.S. and other foreign manufacturers would be compelled to work with and through these companies, some of which were competitors, and provide them with technical product specifications. Following high-level bilateral engagement, AQSIQ, SAC and CNCA jointly announced that China would suspend indefinitely its proposed implementation of WAPI as a mandatory wireless encryption standard, that it would work to revise its WAPI standard, taking into account comments received from Chinese and foreign enterprises, and that it would participate in international standards bodies addressing WAPI and wireless encryption for computer networks generally.

New Chemical Regulation

In September 2003, China's State Environmental Protection Administration (SEPA) issued a regulation requiring manufacturers and importers of new chemicals to apply to SEPA's Chemical Registration Center (CRC) for approval and to provide extensive test data to substantiate the physical properties, consumer safety and environmental impact of the new chemical. U.S. industry is primarily concerned that CRC has not been able to make decisions on the approval of new chemicals in a timely manner. U.S. industry estimates that U.S. companies have submitted 35-40 completed applications for new chemicals since October 15, 2003. According to the most recent information available from CRC, approximately 10 of these applications have been approved. U.S. industry notes that several applications have been pending well beyond the 120-day timeline set forth in the regulation. U.S. industry also complains of shifting requirements and implementation changes, such as recently expanded eco-toxicity testing requirements, which mandate that certain eco-toxicity testing (fish eco-toxicity and bio-degradation studies) be carried out in one of six SEPA-accredited laboratories in China. These accredited laboratories have all been established since summer 2004 (in response to the regulation) and industry fears that if inexperience leads one of these new labs to declare a product unsafe, it could affect sales globally. China's lack of a low-volume exemption (exemption where trade in a given chemical falls below an annual volume threshold) also appears to hinder the importation of U.S. chemicals, particularly for high value specialty chemicals sold in small quantities.

FOREIGN TRADE BARRIERS

Scrap Recycling

In late 2003, China's AQSIQ issued a notice requiring overseas scrap material exporters to register with AQSIQ. The stated purpose of the new requirement was to better monitor the entry of scrap shipments into China reportedly due to high occurrences of receiving dangerous waste and illegal material in past shipments from overseas. It was not until May 2004 that AQSIQ issued the implementing rules. These rules established registration procedures, including an application deadline of July 1, 2004, and set substantive requirements. In response to U.S. and other WTO members' concerns that the application period was too short, AQSIQ extended the application deadline to August 1, 2004, allowed companies who submitted incomplete applications to supplement required documents and extended the new requirement's effective date from November 1, 2004 to January 1, 2005.

AQSIQ made public on its website the names of overseas exporters approved to ship scrap to China in two postings, the first in mid-October and the second at the end of December, only days before the new registration would take effect. In total, about 85 percent of worldwide applicants were granted approval, including hundreds of U.S. exporters. AQSIQ indicated that it would notify applicants that were not approved and that these exporters would be able to apply again six months after receiving notice of their rejection. However, AQSIQ has not given any formal notice about when it will re-open the application process to exporters or new shippers that missed the original deadline.

Quality and Safety Certification

China's "China Compulsory Certification" (CCC) mark system took full effect on August 1, 2003, following a transition period that lasted for fifteen months. The new CCC mark replaces the old "Great Wall" and "CCIB" marks and is now required for more than 130 product categories, such as electrical machinery, information technology equipment, household appliances and their components. Despite this positive change, U.S. companies in some sectors complain that certification remains a difficult, time-consuming and costly process. The process involves on-site inspection of manufacturing facilities outside of China, the cost of which is borne by producers. Some U.S. companies also report that China is applying the CCC mark requirements inconsistently, with Chinese customs officials blocking shipments that should not require a mark. In addition, small and medium-sized U.S. companies without a presence in China find it particularly burdensome to apply for CCC mark exemptions (including for replacement and re-export) because China requires the applications to be done in person in the Beijing offices of CNCA. U.S. companies have also asked China not to require the CCC mark for products that no longer warrant mandatory certification, such as low-risk products and components.

In February 2004, AQSIQ issued a measure requiring that owners of overseas certification markers file with state certification authorities. AQSIQ also issued a measure in June 2004 requiring that testing and certification institutions be officially designated by CNCA before

FOREIGN TRADE BARRIERS

conducting business related to products subject to compulsory certification. China has accredited 66 Chinese enterprises to test products for the CCC mark and 5 Chinese enterprises to certify them. Despite China's WTO commitment that qualifying foreign-owned conformity assessment bodies would be eligible for accreditation, China has yet to grant accreditation to any foreign-invested enterprises.

Redundant Testing

U.S. companies have expressed concern about continued requirements for redundant testing, particularly for cosmetics, pharmaceuticals, medical equipment, cellular telephones and other telecommunications products and consumer electronic products. For example, telecommunications equipment faces CNCA quality and safety tests, but then MII conducts functionality tests that overlap the CNCA tests.

Sanitary and Phytosanitary Measures

Prior to China's accession to the WTO, the United States and other WTO members were concerned about a variety of China's phytosanitary and veterinary import standards that appeared to be based on dubious scientific principles and had not always been consistently applied. To advance its bid to join the WTO, China addressed certain longstanding sanitary and phytosanitary (SPS) barriers to U.S. agricultural imports when it agreed to lift bans on imports of U.S. grain, citrus, meat and poultry with the signing of the U.S.-China Agricultural Cooperation Agreement (ACA) in April 1999. In particular, China agreed to recognize the U.S. certification system for meat and to accept U.S. beef, pork, and poultry meat from all USDA-certified plants. China also lifted its ban on imports of citrus from the United States, allowing imports of citrus from most counties in Arizona, California, Florida, and Texas. In addition, China lifted its ban on imports of wheat and other grains from the U.S. Pacific Northwest and promised to allow the import of U.S. wheat meeting specified tolerances for TCK fungus. China's implementation of the ACA has produced mixed results, however.

With regard to raw poultry and meat, China continues to apply certain standards that do not appear to be based on scientific evidence and that have the effect of slowing imports from the United States. In particular, in 2002, China declared zero tolerance for pathogens in imported raw poultry and meat. While it is possible to reduce contamination through cooking, the complete elimination of pathogens in raw poultry and meat is not reasonably achievable, nor scientifically justifiable. Moreover, China apparently does not apply this same standard to domestic raw poultry and meat, which would appear contrary to WTO national treatment principles.

China issued a new phytosanitary measure in 2004 blocking imports of cherries from the United States.

FOREIGN TRADE BARRIERS

China also continued to delay the approval of citrus imports from four counties in Florida and to use a variety of phytosanitary measures to block imports of several other U.S. products, including stone fruit, several varieties of apples, pears, fresh potatoes and processed food products containing certain food additives. By the end of 2004, China had agreed to lift the ban on the Florida citrus imports. China had also lifted the ban on cherries, except for those originating in California.

While the 1999 ACA 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, China has imposed a maximum residue level (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 increased dramatically in 2004, as China does not appear to be enforcing them.

Meanwhile, in December 2003, China and other countries imposed bans on U.S. bovine products in response to the detection of bovine spongiform encephalopathy (BSE) in a cow imported into the United States from Canada. China's ban included not only beef, but low-risk bovine products, i.e., bovine semen and embryos, protein-free tallow and non-ruminant origin feeds and fats, which pose no risk of BSE and should not be banned under existing international standards. After numerous bilateral meetings and technical discussions, including a visit to U.S. bovine facilities by Chinese food safety officials, China announced a lifting of its BSE ban for low-risk ruminant bovine 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 bovine products. In November 2004, U.S. and Chinese officials finalized and signed protocols that would enable a resumption in exports of U.S.-origin bovine semen and embryos, along with non-ruminant origin feeds and fats. Exports of bovine semen and embryos are contingent on facility certification by Chinese regulatory authorities. U.S. and Chinese officials were unable to reach agreement on provisions that would enable a resumption in exports of U.S.-origin protein-free tallow to China, and by the end of 2004 trade in low-risk bovine products had not yet resumed.

In February 2004, China imposed a nationwide ban on U.S. poultry in response to cases of low-pathogenic Avian Influenza (AI) found in Delaware and did not modify this nationwide ban when a case of highly pathogenic AI was subsequently discovered in Texas. 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. The United States emphasized it had been recognized as free of high pathogenic AI under international standards. In November 2004, China lifted its nationwide ban on U.S. poultry, leaving in place a ban only for the states of Connecticut and Rhode Island. The United States will soon be providing China with requested information regarding the status of AI in those two states.

FOREIGN TRADE BARRIERS

Throughout 2004, China's general lack of transparency remained a problem. China either failed to notify or belatedly notified to the WTO numerous food safety measures, resulting in measures that were adopted without the benefit of comments from other interested WTO members. In some cases, the adopted measures were overly burdensome, appeared to lack a scientific foundation, or raised significant national treatment concerns. U.S. engagement with China at the WTO and bilaterally, including through the provision of technical assistance, generated some improvements in China's compliance with its WTO transparency obligations in 2004. At the same time, however, U.S. exports of soybeans, biotechnologically related products, fruit and other products repeatedly fell subject to unnotified entry, inspection and labeling requirements.

China's Biotechnology Regulations

In January 2002, the Ministry of Agriculture (MOA) issued new rules implementing June 2001 regulations on agricultural biotechnology safety, testing and labeling. The product most affected was soybeans, while corn and other commodities also remained at risk. However, the implementing rules did not provide adequate time for completion of required safety assessments before their effective date of March 20, 2002. In response to U.S. interventions, China issued interim rules, which allowed trade to continue while authorities carried out safety assessments of transgenic products. These interim rules were extended twice and were set to expire in April 2004. In December 2003 talks, MOA officials promised that permanent approval of Round-up Ready soybeans would be completed at least 60 days before expiration of the interim rules, which should prevent any trade disruption. China followed through on this promise and approved Round-up Ready soybeans, along with two cotton events and two corn events, in February 2004. Two months later, China issued final safety certificates for five additional corn events and seven canola events, leaving only one corn event still awaiting final approval. MOA has indicated that action on the remaining corn event can be expected by early 2005.

Substantial U.S. concerns with China's biotechnology regulations and implementing rules remain, particularly with regard to risk assessment (including the administration of field trials), labeling and inter-ministerial coordination of biotechnology policy. China is a signatory to the Convention on Biodiversity, but has yet to ratify the Biosafety Protocol.

Labeling

The U.S. processed food industry has registered its concerns with a number of standards and labeling requirements on its exports to China. The meat industry in particular is concerned that meat labeling regulations issued in late 2002 have several requirements that go beyond those of any other country. They assert that these requirements are unnecessary and costly.

Agricultural importers and importers of processed foods are also concerned about measures requiring labels for products containing transgenic material, such as soybeans and corn. The June 2001 biotechnology regulations issued by MOA require labeling of bulk commodities, but

implementation has been limited and sporadic. Future implementation of these measures remains uncertain.

The distilled spirits industry is concerned that China will require its products to comply with all existing food labeling requirements. The industry believes that some of these requirements are inappropriate since the industry does not consider distilled spirits to be a food.

EXPORT REGULATION

Export Licenses and Quotas

Over the last several years, China has progressively reduced the number of products requiring some type of export license. In 2004, China continued this trend, as it freed up two more categories of products from this requirement (garlic and carbon steel plate). However, 50 categories of products (totaling 319 items at the 8-digit tariff level) are still subject to various types of export licenses. Products requiring export licenses include some grains, cotton, livestock, raw materials and metals, lethal chemicals and food products. In addition, China occasionally imposes new export licensing requirements on strategically sensitive commodities.

For some products, such as blast furnace coke and fluorspar, the export licensing system raised strong concerns under WTO rules that generally prohibit export restrictions. Export licenses for these two products are accompanied by export quotas and at times have required the payment of high export license fees beyond the administrative costs of administering an export license system.

In 2004, China's 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. 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. In late July 2004, China raised the 2004 quota allotment for coke to 12.3 million MT, and it indicated that it would eventually raise 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. 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. U.S. industry was also able to obtain a substantially larger quantity of Chinese coke in 2004 than it had in 2003.

China has imposed quotas and high license fees on exports of fluorspar since before it acceded to the WTO, apparently with the objective of supporting China's domestic users of fluorspar, which face no comparable restrictions. China has refused to modify its practices in this area, despite repeated U.S. requests.

China also requires export licenses on products that are the subject of antidumping duties in a foreign market. The central government has delegated responsibility for issuing these licenses to

FOREIGN TRADE BARRIERS

quasi-governmental industry associations formed to take the place of the ministries that governed production during the earlier central planning era. Foreign investors report that the industry associations are using the power to issue export licenses to force companies to participate in association-supported activities. For example, the steel producers' industry association will not issue an export license to any company that does not contribute to its antidumping defense funds.

December 2004, as the January 1, 2005 deadline for removal of global textile quotas drew near, China announced plans to impose export duties on certain In categories of textile and apparel products. Details of this plan are still unclear but appear to represent an effort by China to manage the export growth of these products in response to concerns from China's trading partners.

Export Subsidies

China officially abolished subsidies in the form of direct budgetary outlays for exports of industrial goods on January 1, 1991. China agreed to eliminate all subsidies prohibited under Article 3 of the WTO Agreement on Subsidies and Countervailing Measures, including all forms of export subsidies on industrial and agricultural goods, upon its accession to the WTO in December 2001.

A general lack of transparency makes it difficult to identify and quantify possible export subsidies provided by the Chinese government. China's subsidy programs are often the result of internal administrative measures and are not publicized. Many of the subsidies take the form of income tax reductions or exemptions that are de jure or de facto contingent on export performance. They can also take a variety of other forms, including mechanisms such as credit allocations, low-interest loans, debt forgiveness and reduction of freight charges. U.S. industry has alleged that subsidization is a key reason that Chinese exports are undercutting prices in the United States and gaining market share. Of particular concern are China's practices in the textiles industry as well as in the steel, petrochemical, high technology, forestry and paper products, machinery and copper and other non-ferrous metals industries.

U.S. subsidy experts are currently seeking more information about several Chinese programs and policies that may confer export subsidies. Their efforts have been frustrated in part because China has failed to make any of its required subsidy notifications since becoming a member of the WTO three years ago. At a meeting of the WTO's Council for Trade in Goods in November 2004, China committed to submit its long-overdue subsidies notification in 2005.

Since shortly after China acceded to the WTO, U.S. corn exporters have been concerned that China provides export subsidies on corn. In 2002 and 2003, 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. In 2004,

FOREIGN TRADE BARRIERS

however, trade analysts began to conclude that, because of several economic factors, including changes in the relationship between domestic prices and world prices, China is now trending toward becoming a net importer of corn.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

While China has made significant progress in its efforts to make its framework of laws, regulations and implementing rules WTO-consistent, serious problems remain, particularly with China's enforcement of intellectual property rights. Throughout 2004, the United States placed the highest priority on the need for improvements in China's enforcement efforts, as counterfeiting and piracy in China are at epidemic levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy. In April 2004, in response to concerns raised by the United States, China's Vice Premier Wu Yi presented an "action plan" to address the IPR problem in China. Intended to "substantially reduce IPR infringement," this action plan calls for improved legal measures to facilitate increased criminal prosecution of IPR violations, increased enforcement activities and a national education campaign. The United States is monitoring implementation of this action plan closely and will conduct an out-of-cycle review in early 2005 under the Special 301 provisions of U.S. trade law to assess China's implementation of its IPR commitments. The United States will take whatever action is necessary at the conclusion of the out-of-cycle review to ensure that China develops and implements an effective system for IPR enforcement, as required by the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). Supplementing these efforts is the Strategy Targeting Organized Piracy (STOP!), a U.S. government-wide initiative begun in October 2004 to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to stop fakes at the U.S. borders, 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.

Legal Framework

In anticipation of its accession to the WTO, China began modifying the full range of IPR laws, regulations and implementing rules, including those relating to patents, trademarks and copyrights, in an effort to comply with the TRIPS Agreement. By the end of 2001, China had completed amendments to its patent law, trademark law and copyright law, along with regulations for the patent law and regulations addressing computer software protection and the protection of layout designs of integrated circuits. After it acceded to the WTO, China issued regulations for the trademark law and the copyright law. China also issued various sets of implementing rules and judicial interpretations in the patent, trademark and copyright areas. Overall, the legal changes made by China represent major improvements that have moved China generally in line with international norms in most key areas, although more work needs to be done, particularly with regard to administrative and criminal enforcement. In addition, new legislation may be required in certain "cutting edge" areas.

FOREIGN TRADE BARRIERS

In the trademark area, some progress was made in 2004 on the recognition of foreign well-known marks, more than a year after the issuance of implementing rules in June 2003 on well-known marks. A handful of foreign marks have been recognized as well-known by the China Trademark Office, all in the last year. The State Administration for Industry and Commerce also announced plans to amend its Regulations on Trademark Administrative Enforcement in order to guide regional industrial and commercial administrations in facilitating effective trademark enforcement and protection. Nevertheless, the administrative enforcement system for trademarks is generally regarded by U.S. industry as non-deterrent. The fines remain very low, and new measures are needed to clarify the conditions for imposing administrative penalties, including the calculation of fines and the destruction of counterfeit and pirated products and the equipment used to make them.

By the end of 2004, with copyright infringement on the Internet becoming a growing phenomenon in China because of loopholes in existing regulations and implementing rules, China still had not acceded to two World Intellectual Property Organization (WIPO) treaties, the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty. These treaties, commonly known as the “WIPO Internet treaties,” entered into force in 2002 and have been ratified by many developed and developing countries. The United States considers the WIPO treaties to reflect many key international norms for providing copyright protection over the Internet. While China’s existing regulations, implementing rules and judicial interpretations do increasingly address certain copyright issues related to the Internet, and China is currently drafting further Internet-related regulations to provide better IPR protection on the Internet, China needs to accede to the WIPO treaties and harmonize its regulations and implementing rules with them to meet international norms. China’s accession to the WIPO treaties is an increasingly important priority for the United States and many other countries because China has the second largest number of Internet users of any country in the world, and rapid growth in broadband penetration in China not only increasingly affects China’s market but also foreign markets due to the borderless nature of the Internet.

China also took steps in 2004 to improve border measures meant to protect against the import and export of infringing products and to make it easier for rights-holders to secure effective enforcement at the border when the Customs Administration issued new regulations and implementing rules. These measures address the duties of the Customs Administration and improve guidance on the implementation of the customs IPR recordal mechanism. However, in other areas, such as the storage and disposition of infringing goods and the transferral of cases for possible criminal prosecution, these measures lack clarity or could benefit from further changes.

Enforcement

Although the central government has worked effectively to modify a range of China’s IPR laws and regulations in an effort to bring them into line with China’s WTO commitments, IPR

FOREIGN TRADE BARRIERS

enforcement continues to be inadequate. In 2004, IPR infringement in China continued to affect products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, textile fabrics and floor coverings, consumer goods, electrical equipment, automotive parts and industrial products, among many others. According to figures released by the State Council's Development Research Center in July 2003, the market value of counterfeit goods in China was between \$19 billion and \$24 billion in 2001, which translates into enormous losses for intellectual property rights-holders. According to some reports, inadequate enforcement has resulted in infringement levels in China that have remained at 90 percent or above in 2004 for virtually every form of intellectual property, while estimated U.S. losses due to the piracy of copyrighted materials alone range between \$2.5 billion and \$3.8 billion annually. This situation not only has had an enormous economic impact, but also presents a direct challenge to China's ability to regulate many products that have health and safety implications for China's population and, as an increasing amount of counterfeit and pirated products are being exported from China, for others around the world.

China's IPR laws and regulations provide for three different mechanisms for IPR enforcement – enforcement by administrative authorities, criminal prosecutions and civil actions for monetary damages or injunctive relief. However, China's IPR enforcement efforts are hampered by the challenges of coordination among Chinese government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting cases, and inadequate and non-transparent administrative penalties.

The United States has repeatedly urged China to take immediate and substantial steps to put it on the path toward effective enforcement mechanisms, and it has also sought to foster improvements through a variety of technical assistance programs. Following a series of high-level meetings, China announced a comprehensive action plan on IPR enforcement in April 2004, with the stated goal of significantly reducing infringement across the country. China specifically committed that it would: (1) significantly reduce IPR infringement levels; (2) take steps by the end of 2004 to increase penalties for IPR violations by subjecting a greater range of violations to criminal investigation, applying criminal sanctions to the import, export, storage and distribution of pirated and counterfeit products and applying criminal sanctions to on-line piracy; (3) crack down on IPR violators by conducting nation-wide enforcement actions and increasing customs enforcement actions; (4) improve protection of electronic works by ratifying and implementing the WIPO Internet treaties as soon as possible, and by extending an existing ban on the use of pirated software in government offices; and (5) launch a national IPR education campaign. China also agreed to establish an IPR working group that would function under the auspices of the JCCT to consult and cooperate with the United States on the full range of issues described in China's IPR action plan.

In the months following these commitments, Vice Premier Wu Yi pledged that China would move forward with the legislative and judicial measures needed to improve China's IPR protection regime. Vice Premier Wu Yi also made clear that China would turn its attention to

FOREIGN TRADE BARRIERS

educating consumers and enforcing laws already in place. In August 2004, Vice Premier Wu Yi proclaimed that China would soon launch a year-long campaign targeting IPR infringement that would focus on “key stages,” including import/export activities, trade fairs and exhibitions, wholesale markets, processing of brand name goods, printing and replication. This campaign seeks to integrate the work of multiple government agencies in order to combat IPR abuses in fifteen provinces and cities designated for priority action, both for enforcement and education purposes, and is scheduled to proceed in three phases: (1) planning and mobilization (September 2004); (2) implementation (October 2004 to June 2005); and (3) summary (July to August 2005). Meanwhile, in late December 2004, the Supreme People’s Court and Supreme People’s Procuratorate issued a judicial interpretation intended to address a variety of problems with criminal enforcement in China.

Administrative Enforcement

China continues to take a large number of administrative enforcement actions against IPR violators. However, these actions do not appear to deter further IPR infringement.

In 2004, under the leadership of Vice Premier Wu Yi, the central government initiated anti-counterfeiting and anti-piracy campaigns. These campaigns resulted in high numbers of seizures of infringing materials. Nevertheless, the cases subsequently brought by the administrative authorities in connection with these types of campaigns usually result in extremely low fines. When the administrative authorities decide on fines, the amounts can be artificially low because the administrative authorities often establish value based on the price charged for the counterfeit or pirated goods rather than treat the infringing goods as having the value of the genuine articles. In addition, evidence showing that a person was caught warehousing infringing goods is not sufficient to prove an intent to sell them, and as a result the administrative authorities will not even include those goods in the value of the infringing goods when determining the fine amounts. The lack of deterrence from the fines is compounded by the fact that the administrative authorities rarely forward an administrative case on to the Ministry of Public Security for criminal investigation, even for commercial-scale counterfeiting or piracy. As a result, the infringers consider the seizures and fines simply to be a cost of doing business, and they are usually able to resume their operations without much difficulty.

In bilateral meetings with China in 2004, the United States continued to emphasize that China needs to revise its IPR legal framework to provide for substantially higher administrative fines and that, for these fines to have a deterrent effect, the administrative authorities need to provide greater transparency throughout the enforcement process, issue written decisions and publicize the results. The United States has also emphasized that it is crucial for the administrative authorities to establish clear standards for the transfer of cases to the Public Security Bureau and the Supreme People’s Procuratorate for criminal prosecution.

Criminal Enforcement

Effective criminal enforcement could offer the deterrence needed for China to begin to handle the rampant IPR infringement hurting both foreign and domestic enterprises. At present, however, criminal enforcement has virtually no deterrent effect on infringers. China's authorities have pursued criminal prosecutions in a relatively small number of cases. While the number of criminal trademark prosecutions is increasing, very few criminal copyright prosecutions have been initiated. When criminal prosecutions are pursued, moreover, a lack of transparency makes it sometimes difficult to find out if they resulted in convictions and, if so, what penalties were imposed and whether the penalties were suspended.

Prior to the issuance of the December 2004 judicial interpretation on criminal enforcement, the United States had called for several critical legal changes. A key concern for the United States involved criminal liability thresholds, which were very high and seldom met. In order to bring a criminal action against an alleged infringer, evidentiary proof of sales totaling RMB 200,000 (\$24,100) for enterprises and RMB 50,000 (\$6,030) for individuals was required. This proof-of-sale requirement was unworkable, as it did not apply to counterfeit or pirated goods discovered in a warehouse but not yet sold, and infringers generally do not issue receipts or keep detailed records of the sales that they have made. In addition, the United States was concerned about the scope of China's laws and regulations. For example, it was clear that China's laws and regulations would be much more effective if they applied to the willful manufacture, storage, distribution and use of counterfeit and pirated goods, rather than only when a sale could be proved. Similarly, China's failure to treat the export of counterfeit or pirated goods on a commercial scale as a criminal act was problematic.

An initial review of the judicial interpretation issued by the Supreme People's Court and the Supreme People's Procuratorate in late December 2004 shows that it reduces the monetary thresholds for criminal prosecutions of trademark and patent counterfeiting and copyright piracy and contains new provisions addressing online copyright piracy and accomplice liability, including the import/export of counterfeit goods. It is too early to tell how effective this judicial interpretation will be in improving China's criminal enforcement record. As drafted, the judicial interpretation is only an initial step in rectifying China's deficient criminal enforcement system. The changes set forth in the judicial interpretation will not, by themselves, result in significantly decreased infringement levels. Rather, the central government must also issue clear mandates to the Public Security Bureau, the Supreme People's Procuratorate, the Customs Administration and other IPR enforcement agencies as well as the courts requiring them to undertake corresponding institutional reforms of their investigatory and prosecutorial guidelines and practices. Standards for referrals from the administrative system to the criminal system must also be clarified and brought in line with the judicial interpretation. In addition, the central government must ensure appropriate allocation of resources and expertise to the IPR enforcement agencies, while also providing rigorous oversight, in order to ensure that these agencies coordinate their enforcement activities and improve their ability to effectively investigate, prosecute and ultimately convict IPR criminals.

FOREIGN TRADE BARRIERS

Civil Enforcement

In part because of the ineffectiveness of the administrative and criminal enforcement mechanisms in China, there has been an increase in the number of civil actions being brought for monetary damages or injunctive relief. Most of these actions have been brought by Chinese rights-holders. This increased use of civil actions has coincided with an increasing sophistication on behalf of China's IPR courts, as China continues to make efforts to upgrade its judicial system. These efforts are still in progress, however. U.S. companies continued to complain in 2004 that there is still a lack of consistent and fair enforcement of China's IPR laws and regulations in the courts. They have found that most judges lack necessary technical training and that court rules regarding evidence, expert witnesses, and protection of confidential information are vague or ineffective. In addition, in the patent area, where enforcement through civil litigation is of particular importance, a single case still takes four to seven years to complete, rendering the new damages provisions adopted to comply with China's TRIPS Agreement obligations less meaningful.

SERVICES BARRIERS

Until China's entry into the WTO, China's services sectors were among the most heavily regulated and protected sectors of the national economy. Foreign service providers were largely restricted to operations under the terms of selective "experimental" licenses. However, both as a matter of policy and as a result of its WTO commitments, China decided to significantly liberalize foreign investment in its service sectors. At present, the market for services, underdeveloped due to historical attitudes and policies, has significant growth potential in both the short and long term.

China's WTO commitments are designed to provide meaningful access for U.S. service providers. In its accession agreement, 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 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

FOREIGN TRADE BARRIERS

licensing area, prior to China's WTO accession, foreign companies in many sectors did not have an unqualified right to apply for a license to operate 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.

In 2004, China made progress on some fronts. For example, China lifted geographic restrictions in the banking and insurance sectors on or ahead of schedule. In addition, the licensing process in many sectors proceeded in a workman-like fashion. Indeed, every U.S. insurer that has applied to enter the China market has received a license, while some licenses have been granted to U.S. and other foreign institutions in the non-bank motor vehicle financing sector. China also went beyond its WTO commitments when it entered into bilateral aviation and maritime agreements with the United States.

However, many challenges remain in securing the benefits of China's services commitments. While China continued to keep pace nominally with the openings required by its WTO accession agreement, it frequently maintained or erected terms of entry that were so high or cumbersome as to prevent or discourage many foreign suppliers from gaining market access. For example, despite some progress, excessive capital requirements continue to restrict market entry for foreign suppliers in many sectors, such as insurance, banking, telecommunications and non-bank motor vehicle financing, among several 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 express delivery and construction services, problematic measures continue to threaten to take away previously acquired market access rights.

Insurance Services

China's insurance market is growing steadily, but not as quickly as it could. According to the China Insurance Regulatory Commission (CIRC), 2004 premium income totaled \$52 billion, an increase of 11.3 percent from 2003. Total insurance company assets reached \$142 billion, an increase of nearly 30 percent from the previous year. In 2004, the operations of foreign insurers in China had continued to expand. Foreign insurer premium income grew by over 45 percent to \$1.2 billion, or 2.3 percent of total premiums. While foreign insurers still have a relatively low share of the national market, in some areas market share is increasing. According to CIRC, in 2004, the 37 foreign insurers present in China held a 15.3 percent market share in Shanghai and an 8.2 percent market share in Guangzhou.

In its WTO accession agreement, China agreed to phase-in expanded ownership rights for foreign companies, for the most part during the first three years of China's WTO membership. Upon China's accession to the WTO, foreign life insurers were to be permitted to hold 50 percent equity share in a joint venture; within two years of accession, foreign property, casualty

FOREIGN TRADE BARRIERS

and other non-life insurers were to be permitted to establish as a branch, joint venture or a wholly foreign-owned subsidiary; and, within three years of accession, or by December 11, 2004, foreign insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance were to be permitted 51 percent foreign equity share in a joint venture (with the right to establish as a wholly foreign-owned subsidiary within two more years). China further agreed that all foreign insurers would be permitted to expand the scope of their activities to include group, health and pension lines of insurance within by December 11, 2004. In addition, China agreed to eliminate geographic restrictions on all types of insurance operations by December 11, 2004.

Shortly after China acceded to the WTO, CIRC issued several new insurance regulations, 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, China's capitalization requirements were significantly more exacting than those of other populous countries, and they limited the ability of foreign insurers to make necessary joint venture arrangements. The regulations also continued to permit considerable bureaucratic discretion and to offer limited predictability to foreign insurers seeking to operate in China's market. With regard to branching, China scheduled a commitment to allow non-life 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. China's regulations regarding foreign insurers' branching rights, however, remain vague, and CIRC has so far insisted that non-life insurers that are already in the market as a branch and that wish to branch or sub-branch cannot do so unless they first establish as a subsidiary, a costly condition. Further complicating this issue, CIRC has apparently waived this requirement for at least one foreign non-life insurer, but has not explained how or whether other foreign insurers could apply for this waiver.

In May 2004, CIRC took steps to address concerns related to China's high capitalization requirements by issuing the Detailed Rules on the Regulations for the Administration of Foreign-Invested Insurance Companies. These new rules lower capital requirements for national licenses from RMB 500 million (\$60.3 million) to RMB 200 million (\$24.1 million) and for branch offices from RMB 50 million (\$6.03 million) to RMB 20 million (\$2.41 million). These changes have been welcomed by some U.S. insurers, but others still consider them to be too high. The new rules also streamlined licensing application procedures and shortened approval times, although some procedures remained unclear. Meanwhile, the new rules did not adequately address branching rights, as many aspects of this issue remained vague.

In December 2004, in accordance with its WTO commitments, China lifted its geographic restrictions on foreign insurers on schedule. China also permitted foreign insurers to offer health

FOREIGN TRADE BARRIERS

and group insurance as well as pension/corporate annuities and increased the 50 percent ceiling on foreign ownership of joint venture insurance brokerages to 51 percent.

While China's lifting of geographic restrictions was a welcome development, U.S. and other foreign insurers are concerned that apparent discrimination in branching approvals may limit their ability to expand. In practice, it appears that established Chinese insurers are being granted new branch approvals on a concurrent basis, meaning more than one branch at a time. In contrast, foreign insurers so far have only received approvals on a consecutive basis, meaning one branch at a time. Meanwhile, a number of U.S. investors have taken significant minority equity stakes in major Chinese insurance companies as a means of accessing China's insurance market.

Banking and Securities Services

China put in place laws and regulations implementing its WTO commitments for banking and securities services during its first three years as a WTO member. Foreign banks and securities firms, however, continue to face a restrictive regulatory environment.

As part of its WTO accession agreement, China agreed to allow foreign banks to conduct local currency business with Chinese companies two years after WTO entry, and with Chinese individuals five years after WTO entry. The Chinese government also committed to opening four new cities every year where foreign banks could engage in local currency operations. All non-prudential market access and national treatment restrictions on foreign banks are to be lifted within five years of China's accession to the WTO.

China continues to have strict limitations, in particular, on foreign banks' participation in local currency operations, which are regulated by the People's Bank of China (PBOC). These restrictions are being gradually relaxed, but local currency transactions with individuals remain prohibited until December 11, 2006. Restrictions on the rights of foreign banks to raise RMB in the interbank market also inhibit the ability of foreign banks to build RMB loan portfolios necessary for profitable operations in China. Meanwhile, although foreign currency business with any customer, foreign or domestic, is now freely permitted, only a limited number of China banks are allowed to do forward foreign exchange contracts.

Under regulations issued in December 2001, foreign banks must meet stringent criteria such as having gross assets of \$20 billion when opening new branches in China. Although China reduced capital requirements for foreign bank branches in December 2003, they remained excessively high, increasing local capital costs for foreign banks. Foreign bank branches must also place 30 percent of their operating capital in interest bearing assets designated by the PBOC. Foreign bank branch current assets (cash, local bank demand deposits, and PBOC deposits) must continue to be greater than 25 percent of customer deposits. In addition, the ratio of customer deposits in foreign currency to domestic foreign currency assets may not exceed 70 percent, an increase from the 40 percent-level mandated previously. China calculates prudential ratios and

FOREIGN TRADE BARRIERS

limits based on the local capital of foreign bank branches rather than on the global capital base of the bank, although more lenient rules apply in authorized cities in the northeastern and western regions of China.

In December 2003, the Chinese Government increased the stake a single foreign investor can take in a Chinese bank from 15 to 20 percent, with a total 24.9 percent allowed for all foreign investors. Several foreign (including U.S.) banks and financial institutions have since taken significant equity stakes in small and medium sized Chinese banks. Similar investments are expected when two of China's largest state-owned banks list in the market in 2005. As of December 2004, China had opened up five new cities – Kunming, Beijing, Xiamen, Xi'an and Shenyang – to foreign banks seeking to conduct local currency business, bringing the total number to 18.

Pursuant to the terms of China's WTO accession agreement, foreign securities firms were to receive the right to form joint ventures for fund management upon China's accession to the WTO, while joint ventures for securities underwriting were to be permitted within three years after accession. The China Securities Regulatory Commission issued regulations on the establishment of joint venture fund management companies and securities underwriting by Chinese-foreign joint ventures shortly after China's WTO accession. China's decision to limit foreign partners to a minority stake of these joint ventures, however, continues to limit their appeal to leading foreign firms. In addition, China continues to limit the security underwriting joint ventures to underwriting A-shares and to underwriting and trading government and corporate debt, B-shares and H-shares.

Since December 2002, China has allowed Qualified Foreign Institutional Investors (QFIIs) to trade in A-shares via special accounts opened at designated custodian banks. Stringent criteria currently make it difficult for foreign institutions to qualify as QFIIs, while other requirements limit the extent to which QFIIs can trade in A-shares.

Motor Vehicle Financing Services

China's WTO accession agreement required China to allow foreign non-bank financial institutions to provide motor vehicle financing immediately upon accession and without any limits on market access.

As a result of persistent U.S. engagement with China, both bilaterally and at WTO meetings, China issued regulations in October and November 2003 allowing foreign non-bank financial institutions to provide motor vehicle financing. The capital requirements set by these regulations are relatively high, with minimum registered capital at RMB 300 million (\$36.2 million), and minimum paid-in capital at RMB 500 million (\$60.3 million). In August 2004, CBRC granted licenses for one U.S. auto company and two other foreign auto companies to set up non-bank motor vehicle financing institutions.

FOREIGN TRADE BARRIERS

Wholesaling Services and Commission Agents' Services

In its WTO accession agreement, China committed to provide national treatment and eliminate market access restrictions for foreign enterprises seeking to provide wholesaling and commission agents' services and related services, such as repair and maintenance 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 these services pursuant to a set schedule. The phase-in of these services was supposed to start with minority foreign-owned joint ventures by December 11, 2002, followed by majority foreign-owned joint ventures by December 11, 2003.

Shortly after acceding to the WTO, China fell behind in its implementation of the required progressive liberalization, as foreign enterprises continued to face a variety of restrictions. It was not until mid-2004, following high-level U.S. engagement, that China began to take steps to liberalize. At that time, MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing wholesaling services and commission agents' services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004. However, MOFCOM's failure to clarify the procedures for securing the necessary approval certificates has delayed foreign enterprises' provision of these services.

Retailing Services

In 1999, the Chinese government broadened the scope for foreign investment in the retail sector. New regulations encouraged the entry of large international retailers (such as hypermarkets and warehouse-style stores) into China. China's subsequent WTO commitments were designed to further expand the ability of foreign retailers to enter the market through a much wider range of modalities. Smaller retail operations, some large retail operations, gas stations and even car dealerships may be wholly foreign-owned within three to five years of China's December 2001 WTO accession, although certain types of large retail operations may still face ownership limitations. In addition, franchising was to be permitted within three years of accession, or by December 2004.

As in the wholesale area, China fell behind in its implementation of the required progressive liberalization shortly after acceding to the WTO, as foreign enterprises continued to face a variety of restrictions. China only began to take steps to liberalize in mid-2004, when MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing retailing services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004. However, MOFCOM's failure to clarify the procedures for securing the necessary approval certificates has delayed foreign enterprises' provision of these services.

Sales Away From a Fixed Location

In 1998, China banned all direct selling (or sales away from a fixed location) activities after some foreign and domestic firms used direct selling techniques to operate pyramid schemes and other less-than-legitimate operations. Some large U.S. and other foreign direct selling firms were allowed to continue operating in China after altering their business models. In its WTO accession agreement, China committed to the full resumption of direct selling activities by December 2004. At the end of 2004, however, China was still drafting the necessary implementing regulations. Moreover, it appears that the latest version of the draft direct selling measures may contain several problematic provisions. For example, one provision raises serious national treatment concerns, as it apparently allows direct selling of domestically produced goods, but requires imported goods to be sold at a fixed location. Other provisions, meanwhile, impose operating requirements that may make direct selling commercially unviable.

Express Delivery Services

Beginning in December 2001, the State Postal Bureau (together with MOFTEC and MII) issued restrictive measures that could have jeopardized market access that foreign express delivery firms (which must operate as joint ventures with Chinese partners) enjoyed prior to China's accession. These measures threatened to curtail the scope of operations of foreign express delivery firms licensed prior to China's accession to the WTO, despite China's horizontal commitment on acquired rights. Specifically, Notice 629, issued in December 2001, required firms wishing to deliver letters to apply for entrustment with China Post. Notice 64, issued in February 2002, extended China Post's monopoly on letters by creating weight and rate restrictions on letter deliveries by private firms. Following high-level U.S. interventions, in September 2002, Notice 472 eliminated the weight and rate restrictions on letter deliveries and streamlined the entrustment application procedure. Two major U.S. express delivery firms subsequently applied for and obtained entrustment certificates from China Post.

In July 2003, however, China circulated draft amendments to its postal services law that generated two immediate concerns among U.S. companies. 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. In September, October and November 2003, China circulated new sets of draft amendments. While each set of draft amendments included a different definition of the China Post monopoly, the most recent draft amendments continued to provide China Post with a monopoly on letters weighing less than 500 grams. They also included other problematic provisions. For example, they appeared to create a new, more burdensome licensing process, and they seemed to require express couriers to pay a percentage of their revenue from the delivery of letters into a universal service fund.

In April 2004, following high-level U.S. engagement urging China not to cut back on the scope of activities that foreign-invested express delivery companies had been licensed to provide prior to China's WTO accession, Vice Premier Wu Yi committed that old problems, like the weight restriction, would not resurface as new problems. In July 2004, however, the State Council circulated another set of draft amendments to the postal services 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. No new sets of draft amendments were circulated during the remainder of 2004, as U.S. engagement continued.

Construction, Engineering, Architectural and Contracting Services

Since before China's WTO accession, U.S. construction, engineering and architectural firms and U.S. contractors have enjoyed a relatively cooperative and open relationship with the Chinese government. These firms have operated in the Chinese market through joint venture arrangements and have been less affected by regulatory problems than other service sectors. Nevertheless, they have also faced restrictions. It has been difficult for foreign firms to obtain licenses to perform services except on a project-by-project basis. Foreign firms have also faced severe partnering and bidding restrictions.

In September 2002, the Ministry of Construction and MOFTEC jointly issued Decrees 113 and 114, which opened up construction and related construction design services to joint ventures with majority foreign ownership and, two years ahead of schedule, wholly foreign-owned enterprises. At the same time, however, these decrees 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 required foreign firms to obtain qualification certificates, effective October 1, 2003. In addition, these decrees for the first time required foreign-invested firms supplying construction services to incorporate in China, and they impose high minimum registered capital requirements and foreign personnel residency requirements that are difficult for many foreign firms 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. In September 2003, the Ministry of Construction agreed to extend the implementation date from October 1, 2003 until April 1, 2004 so the concerns of foreign firms could be analyzed further.

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 1, 2005, effectively extending the effective date of the incorporation-related requirements. After that date, U.S. and other foreign companies will face a great deal of uncertainty as they seek to participate in projects in China.

FOREIGN TRADE BARRIERS

In late November 2004, the Ministry of Construction issued the Provisional Measures for Construction Project Management (known as Decree 200), scheduled to become effective on December 1, 2004. Among other things, Decree 200 appears to preclude the same company from providing construction services and related construction engineering design services if it is also providing project management services on the same project. This aspect of the decree raises concerns because U.S. companies often provide all of these services in combination when working on a project in a foreign market.

Meanwhile, foreign firms cannot hire Chinese nationals to practice engineering and architectural services as licensed professionals. Currently, Chinese architecture and engineering firms must approve and stamp all drawings prior to construction. There have also been instances in which U.S. architectural firms have had to pay Chinese domestic taxes on designs prepared in the United States for Chinese projects. China also sets extremely low design fees, rather than letting the market set prices. In addition, China does not have adequate lien laws to protect the rights of engineering and architectural firms from non-payment.

Transportation and Logistics Services

The transportation and logistics sector has in the past faced severe regulatory restrictions, high costs, dominance by government-invested agents, and limitations on permitted activities. The multiple government bodies responsible for this sector include: the Ministry of Communications, the Ministry of Railways, MOFCOM, NDRC and the Civil Aviation Administration of China. Overlapping jurisdictions, multiple sets of approval requirements, and opaque regulations hinder market access. In some areas, domestic firms have used government connections and investments to monopolize the sector.

Nevertheless, like China's own reform policies, China's WTO commitments support a broad opening of the transportation and logistics sector to foreign services providers, to be phased in over time. Foreign firms should be able to invest freely in warehousing, road freight transport, rail freight transport and freight forwarding companies within three to six years after WTO accession, depending on the sector.

In July 2002, MOFCOM's predecessor, MOFTEC, issued a Notice on Establishing Foreign-Invested Logistics Companies in Trial Regions. This notice allows foreign-invested logistics companies (with up to 50 percent foreign ownership and registered capital of \$5 million) to establish in several designated cities. U.S. firms have expressed concern about the high capital requirement and the 50 percent cap on foreign ownership, which may conflict with China's WTO commitments for certain types of logistics services.

In November 2002, China issued regulations allowing majority foreign ownership of road transportation firms, as it was required to do within one year of its WTO accession. China was also obligated to issue regulations allowing majority foreign-owned joint ventures to enter the

FOREIGN TRADE BARRIERS

fields of packaging services, storage and warehousing, and freight forwarding one year after its accession; it issued timely regulations allowing 75 percent foreign-owned joint ventures in these fields.

Even though China made no WTO commitments covering aviation services sector, it took a significant step in July 2004 to increase market access for U.S. passenger and cargo carriers. China signed a landmark amendment to the 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 country's carriers to serve any city in the other country, provides for unlimited code-sharing between them, expands opportunities for charter operators, and eliminates government regulation of pricing as of 2008. U.S. passenger and cargo carriers have since obtained additional routes and increased flight frequencies, as envisioned by the agreement.

Similarly, in late 2003 China took steps to liberalize the maritime services sector despite having made no WTO commitment. The United States and China signed a far-reaching, five-year bilateral maritime agreement, which will give 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, will also be able to establish branch offices in China without geographic limitation.

Regulation of Internet Content and Restrictions on Encryption and Decryption

Chinese authorities routinely filter Internet traffic entering China, focusing primarily on the content they deem objectionable on political, social or religious grounds. In 2002, China lifted filters on most major western news sites. However, according to a Harvard University study, published in 2002, China has blocked 19,032 sites on multiple occasions. In addition to blocking sites related to Taiwan, the Falun Gong spiritual movement, Tibetan and Uighur support groups, and human rights organizations focusing specifically on China, university alumni homepages such as that for MIT, various Church and other religious-themed sites, and search engines such as Alta Vista, have been blocked repeatedly. Foreign news websites were also blocked for several weeks during the 16th National Congress of the Communist Party of China in March 2003. Few, if any, websites related to strictly economic and business matters are blocked. Changes to Internet filtering can occur without warning or public explanation. For example, the popular Internet search engine Google was blocked completely in China for a few weeks starting in late August 2002. When Google became available again in September 2002, its "cached pages" feature remained blocked; that feature had previously allowed users in China to access "snapshots" of some webpages that were otherwise blocked in China. There have been no significant changes to China's policies on Internet content since these developments in 2002.

Internet content restrictions are governed by a number of measures, not all of which are public. The most important of these measures was issued in September 2000 and cover Internet content

FOREIGN TRADE BARRIERS

providers, electronic commerce sites and application service providers. In March 2002, the Internet Society of China, a nominally private group affiliated with MII, established a “Public Pledge on Self-Discipline for the China Internet Industry.” Signatories commit to “refrain from producing, posting or disseminating pernicious information that may jeopardize state security and disrupt social stability, contravene laws and regulations and spread superstition and obscenity.” At least one Chinese subsidiary of a U.S. Internet firm has signed the pledge.

China generally prohibits foreign-developed encryption and decryption technologies. In the past, this prohibition has not applied to software and hardware for which encryption is only an incidental feature. However, in December 2003, China dramatically changed this precedent with the issuance of standards on encryption for WLAN, which have since been suspended (see the section on “Standards, Technical Regulations and Conformity Assessment Procedures” above).

Telecommunications

In its WTO accession agreement, China made important commitments in the area of telecommunications services. It agreed to permit foreign suppliers to provide a broad range of 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, when it acceded to the WTO, China also accepted key regulatory principles from the WTO Reference Paper. 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 and to implement its regulations in an impartial manner. Since China’s accession, MII has spun-off China Telecom, which now competes in the market with other telecom operators. While the formal separation of regulator and operator has occurred, evidence of continued MII influence over operational decisions of operators (e.g., relating to personnel and standards) suggest that regulatory independence is far from complete. The current regulator, MII, is not structured as an independent entity as it still bears the responsibility to help develop China’s IT and telecom manufacturing industries.

China is also obligated to adopt pro-competitive regulatory principles, such as transparent licensing, cost-based pricing and the right of interconnection, which are necessary for foreign-invested joint ventures to compete against established operators. With practically no foreign participation in the market, it has been difficult to assess compliance with such commitments. This very lack of foreign participation, however, is indicative of a licensing regime that has not been conducive to foreign investment, in part due to lack of transparency.

FOREIGN TRADE BARRIERS

China's Regulations on Foreign-Invested Telecommunications Enterprises went into effect January 1, 2002. They define registered-capital requirements, equity caps, requirements for Chinese and foreign partners, and licensing procedures. The regulations stipulate that foreign-invested telecommunications enterprises can undertake either basic or value-added telecommunications services. Foreign ownership may not exceed 49 percent in the case of basic telecommunications services (excluding wireless paging) and 50 percent in the case of value-added services (including wireless paging, which is otherwise categorized as a basic service). The entire process of forming a Sino-foreign joint venture for basic services pursuant to the new regulations is expected to be lengthy, lasting on average 9 to 12 months. While China committed to giving foreign applicants freedom to choose potential joint venture partners, it appears that MII is interpreting requirements regarding technical qualifications to effectively exclude all but incumbent operators, foreclosing additional competition in the market. For foreign operators interested in offering international services, requirements to use a gateway operated by a state-owned operator appear excessive and unjustified. The capitalization requirement established for new entrants, which exceed \$200 million, is another major impediment to market access. There appears to be no justification for such a requirement, particularly for companies interested in leasing, rather than building facilities, while specific licensing terms for resale-based operators do not appear to exist. Meanwhile, MII continues to process applications very slowly for the few foreign-invested telecommunications enterprises that have attempted to satisfy MII's licensing requirements.

At times, MII has also changed applicable rules without notice and without transparency. For example, in February 2003, MII announced a reclassification of certain basic and value-added telecommunications services effective April 1, 2003. No public comment period was provided for. This move limited the ability of U.S. firms to access China's telecommunications market since basic services are on a slower liberalization schedule and are subject to lower foreign equity limits and higher capitalization requirements.

Little progress has been made in opening the market for value-added services, such as Internet service and content providers. MII announced moves toward convergence in voice, video and data services in 2000, but China considers information content sensitive, so foreign companies face significant barriers in the Internet services sector. Although more foreign companies are registering ".com.cn" websites in China, these sites are still often blocked, which hinders companies' abilities to maintain a stable Internet presence. The requirement that Internet Service Providers (ISPs) must provide user login information and transaction records to authorities upon request, without clear guidelines as to the circumstances and situations that warrant such actions, raises concerns about consumer privacy and prevention of data misuse. Meanwhile, the United States is not aware of a single application for a license to provide value-added services that has completed the MII licensing process.

Foreign equity investment limitations for ISPs and Internet Content Providers (ICPs) mirror the timetable for value-added services in the WTO agreement (30 percent upon accession, 49 percent within one year after accession and 50 percent within two years after accession). However, ICPs

FOREIGN TRADE BARRIERS

must still win the approval of MII and/or local telecom administrations depending on the geographic coverage of their services before they can receive foreign capital, cooperate with foreign businesses, or attempt domestic or overseas stock listings.

In 2004, a draft of the long-awaited Telecommunications Law began to circulate among Chinese ministries and agencies. 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.

Meanwhile, even though China committed in its WTO accession agreement that further liberalization of this sector would be discussed in the current round of WTO negotiations, China has yet to make an improved services offer. With the modest telecommunications commitments made by China in its WTO accession agreement having so far failed to facilitate effective market entry for foreign firms, further liberalization, bound through the current round of WTO negotiations, appears critical to improving market access prospects for this sector.

Audio-Visual Services (Including Film Imports)

China's Regulations on the Administration of Audio-Visual Products and Regulations on the Management of Film went into effect on February 1, 2002. They are designed to bring more order and transparency to the film and audio-visual industries, with an eye to moving toward greater commercial efficiency in accordance with domestic reform efforts and WTO commitments. Despite these positive moves, the desire to protect the revenues earned by the state-owned movie and print media importers and distributors, and China's concerns about politically sensitive materials, result in continued restrictions in audio-visual services. For example, distribution of sound recordings, videos, movies, books and magazines remains highly restricted. In addition news services remain wary that the government will impose new restrictions on their activities. Inconsistent and subjective application of censorship regulations further impedes market growth for foreign and domestic providers alike.

China issued a number of regulations in 2004 that should lead to expanded market access in the audio-visual services sector. In July, the State Administration for Radio, Film and TV (SARFT) issued the Rules for the Administration of China-Foreign Cooperation in Filmmaking. According to these rules, licenses are required for both the joint Chinese-foreign filmmaking cooperative and the cooperating domestic partner. In October, SARFT and MOFCOM issued the Provisional Rules on the Access Requirements for Film. These rules cover film production, distribution, screening and imports by domestic firms, and film production and screenings involving foreign firms. All firms engaged in these businesses are subject to SARFT licensing. Foreign firms are allowed to form joint ventures and cooperative firms engaged in film production, technology and equipment. Joint ventures or cooperative firms must have at least RMB 5 million (\$603,000) of registered capital, and foreign capital cannot make up more than 49 percent of the total share. In October, SARFT and MOFCOM issued the Provisional Rules on the Administration of China-Foreign Joint Venture and Cooperative TV Program Production Firms. The rules establish

FOREIGN TRADE BARRIERS

capital requirements of RMB 2 million (\$241,000) of registered capital, and mandate a share of no less than 51 percent for domestic partners.

China began importing foreign films on a revenue-sharing basis in 1994. The Chinese government limits the number of foreign films allowed to enter China. China allowed in only ten foreign films annually through much of the 1990s, but more recently allowed in twenty foreign films annually on a revenue-sharing basis under its WTO commitments. However, China treats its WTO commitment as a ceiling, rather than a floor, which artificially increases demand for pirated products. Although China is also obligated to open theaters and film distribution to foreign investment, currently there are only two authorized distributors of foreign films, the state-owned China Film Distribution Company and Huaxia. Furthermore, lengthy censorship reviews by Chinese authorities delay the arrival of legitimately imported foreign films on Chinese movie screens. When the films do make it to the screen, they have sometimes been subject to blackout viewing periods during national holidays. China's large black market for foreign films continues to grow because these market access restrictions not only create a demand for pirated DVDs in the absence of legitimately licensed films, but also diminish the incentive for foreign investment in movie theaters. Right holders who comply with Chinese law must forego marketing legitimate products, leaving the demand for movies to be satisfied almost entirely by pirates. This situation somewhat negates the apparent benefits of China's recent raising of the percentage of foreign investment allowed for movie theaters to 75 percent, thus allowing for majority ownership by foreign investors. Some progress was achieved in 2004 when MOFCOM approved a U.S.-invested film distribution joint venture and took steps to shorten the time required to bring films to market.

Tourism and Travel Services

Immediately following China's WTO accession, China issued new travel agency administration regulations to allow large foreign travel and tourism service providers to operate full-service joint venture travel agencies to promote foreign inbound tourism in the four major foreign tourist destinations in China: Beijing, Shanghai, Guangzhou and Xian. China subsequently issued the Provisional Measures for the Establishment of Foreign-controlled and Wholly Foreign-funded Travel Agencies, effective July 2003. For now, the travel agencies must have an annual worldwide turnover in excess of \$40 million, and local registered capital of almost \$500,000. In November 2003, Germany's Touristic Union International (TUI) signed a letter of intent with the China Tourism Agency to form the first joint venture travel agency controlled by a foreign interest since China's accession to the WTO. Japan Airlines has also established the first wholly foreign-funded travel agency.

Foreign firms, however, continue to be restricted from competing in the Chinese outbound tourist market. China requires all travel agents, airlines and other booking entities to use or connect into China's nationally owned and operated computer reservation system when booking airline tickets. Foreign computer reservation companies can only provide reservations by connecting with the Chinese system. The total number of visas issued to Chinese wishing to

FOREIGN TRADE BARRIERS

travel to the United States rose from approximately 85,000 in 2003 to more than 108,000 in 2004, a 27 percent increase. Most of this increase is accounted for by a resumption of normal travel patterns following the containment of the SARS outbreak in China in 2003.

Meanwhile, holders of Chinese official passports, nearly 23,000 of whom were issued U.S. visas in 2004, are required to use China's state-owned airlines or their code-share partners. Most of these individuals are state-owned enterprise employees, who would not be considered government employees in most countries. This represents a significant loss of business for U.S. airlines.

Education and Training Services

China faces a shortage of qualified teachers and clearly needs educators in inland regions. However, the Ministry of Education (MOE) continues to restrict participation by foreign educators and trainers. China permits only non-profit educational activities that do not compete with the MOE-supervised nine years of compulsory education, thereby inhibiting much-needed foreign investment in the education sector. In April 2000, MOE banned foreign companies and organizations from offering educational services via satellite networks. Foreign universities may set up non-profit operations, but must have a Chinese university host and partner to ensure that programs bar subversive content and localize imported information. Meanwhile, China's training market is unregulated, which discourages potential investors from entering the market.

In June 2004, the Ministry of Education issued the Implementing Rules for China-Foreign Cooperative Education Projects. Although formulated to implement the Regulations on China-Foreign Cooperation in Running Schools, issued in September 2003, the rules are only applicable to certain activities, including education offering academic certificates, supplementary education and pre-school education. These activities cannot take the form of actual educational institutions.

Legal Services

Prior to its WTO accession, China maintained various restrictions in the area of legal services. It prohibited representative offices of foreign law firms practicing Chinese law or engaging in profit-making activities with regard to non-Chinese law. 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. Chinese law firms, on the other hand, have been able to open offices freely throughout China since 1996.

As part of its WTO accession, China agreed to lift quantitative and geographical restrictions on the establishment of representative offices by foreign law firms within one year after accession. In addition, foreign representative offices are to be able to engage in profit-making business, to advise clients on foreign legal matters and to provide information on the impact of the Chinese legal environment, among other things. They also are to be able to maintain long-term

FOREIGN TRADE BARRIERS

“entrustment” relationships with Chinese law firms and to instruct lawyers in the Chinese law firm as agreed between the two law firms.

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 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, which would be 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. For example, a foreign law firm may not establish an additional representative office until its most recently established representative office has been in practice for three consecutive years. Foreign attorneys may not take China’s bar examination, and they may not hire registered members of the Chinese bar as attorneys. Although a number of U.S. and other foreign law firms have been able to open a second office in China in 2003 and 2004, little progress has been made on the other problematic aspects of these measures.

Accounting and Management Consultancy Services

Prior to China’s accession to the WTO, foreign accounting firms could not choose their own Chinese joint venture partners freely or enter into contractual agreements that could fully integrate these joint ventures. In its WTO accession agreement, China agreed to allow foreign accounting firms to partner with any Chinese entity of their choice. China also agreed to abandon the prohibition on foreign accounting firms’ representative offices engaging in profit-making activities. Foreign accounting firms can also engage in taxation and management consulting services, without having to satisfy the more restrictive requirements on form of establishment applicable to new entities seeking to provide those services separately.

Meanwhile, the Chinese Institute of Certified Public Accountants, a government body under MOF, has made significant progress in modernizing accounting in China. In 2002, MOF released four newly revised auditing statements covering inter-bank confirmation, capital verification, accounting estimates and the audit of commercial bank financial statements. Furthermore, MOF has been active in standardizing accounting procedures across a wide range of topics including investments, inventories, cash flow statements, and fixed assets. The Chinese Securities Regulatory Commission required listed companies to appoint a certified international CPA firm to conduct audits on prospectuses and annual reports in accordance with international standards. While specific numbers are not available, most observers agree that the demand for internationally qualified accountants will grow rapidly in coming years. Despite these positive changes, pervasive problems remain. Differing accounting regulations limit the comparability of data, and the accounting practices followed by many domestic firms do not meet international conventions.

FOREIGN TRADE BARRIERS

Advertising Services

The State Administration of Industry and Commerce (SAIC) enforces China's 1995 Advertising Law. Among other things, the law bans messages "hindering the public or violating social customs." The law is subject to interpretation by the SAIC, which must approve all advertising campaigns. One additional difficulty for foreign advertising firms, as well as foreign manufacturers, is that China has strict regulations prohibiting comparative advertising as well as any advertising with claims about the relative superiority of one brand over another. Marketing strategies that are successful in some other countries are therefore illegal in China.

In the past, foreign firms had been restricted to representative offices or minority ownership of joint-venture operations. As part of its WTO accession commitments, however, China agreed to allow majority foreign ownership of joint venture advertising companies by December 11, 2003 and wholly foreign-owned subsidiaries by December 11, 2005. In March 2004, SAIC and MOFCOM issued rules governing joint venture, cooperative and wholly foreign-owned advertisement firms. To establish branches, a firm must have paid in full its registered capital and have at least RMB 20 million (\$2.41 million) in annual advertising revenue. Foreign firms are currently limited to a 70 percent share of joint venture and cooperative firms. As of December 2005, wholly foreign-owned advertising firms will be allowed.

Movement of Professionals

Generally, there are no special entry restrictions placed on U.S. professionals who wish to work in China, such as doctors or engineers. However, like other foreign professionals, they must receive approval from the Foreign Experts Bureau. Prior to arrival, a prospective American job applicant may be asked to provide notarized copies of his or her professional credentials and a summary of past work experience. The credentials will be used by the employer to file for a "foreign experts residency permit" for the American employee. Once the "foreign expert" permit is authorized, the prospective employee can request a work visa (a "Z" visa) from a Chinese embassy or consulate. If the prospective employee arrives in China on a visitors' visa (an "L" visa) prior to commencing employment, the prospective employee is usually asked to depart China prior to starting work, and to apply for the appropriate work visa from a foreign entry point (usually Hong Kong). Local employers are responsible for all employment or income tax and other withholdings for these "foreign experts" while they are employed in China. Recent press reports indicate that the government is considering measures to liberalize access by issuing "permanent resident" visas to long-time foreign residents of China. Meanwhile, for long term foreign residents in China, the government is liberalizing access by replacing the "Residence Card" with the "Permanent Resident Visa."

INVESTMENT BARRIERS

Foreign investors continue to show great interest in China despite significant obstacles. According to the United Nations Conference on Trade and Development, China received \$62

FOREIGN TRADE BARRIERS

billion in FDI in 2004, making it the second largest destination for FDI after the United States. General barriers to investment that plague China include lack of transparency, inconsistently enforced laws and regulations, weak IPR protection, corruption and an unreliable legal system incapable of protecting the sanctity of contracts. China's leadership has reaffirmed its commitment to "further open" China to investment and to continue movement toward a rules-based economic system. Foreign (and domestic) companies have reported high profitability in 2004, indicating that challenges to doing business in China have been largely surmountable. Nonetheless, faster concrete progress toward removing investment barriers could spur even more investment, particularly in new, higher value-added manufacturing and services.

Investment Requirements

In addition to taking on the obligations of the WTO Agreement on Trade-Related Investment Measures, China committed in its WTO accession agreement to eliminate export performance, local content and foreign exchange balancing requirements from its laws and regulations and not to enforce any contracts imposing those requirements. China also agreed that it would no longer condition investment (or import) approvals on those requirements or on requirements such as technology transfer and offsets.

In anticipation of these commitments, China revised its laws and regulations on foreign-invested enterprises to eliminate WTO-inconsistent requirements relating to export performance, local content and foreign exchange balancing as well as technology transfer. China also revised "Buy China" policies that regulated procurement of raw materials and fuels, and removed requirements that joint ventures and wholly foreign-owned enterprises submit production/operation plans to Chinese authorities. However, some measures continue to "encourage" technology transfer, without formally requiring it. U.S. companies are concerned that this "encouragement" will in practice 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. In addition, according to U.S. companies, some Chinese government officials 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. While the number of complaints declined in 2004, foreign investors still remain wary of potential violations, as central government commitments to WTO-compliant measures often do not translate into provincial practice.

Investment Guidelines

Foreign investment inflows continue to be controlled and channeled toward areas that support national development objectives. China has adjusted its investment guidelines a number of times over the last six years. The revisions have confused potential investors and added to the perception that the investment guidelines do not provide a stable basis for business planning. Uncertainty as to which industries are being promoted as investment targets and how long such

FOREIGN TRADE BARRIERS

designations will be valid undermines confidence in the investment climate. A new catalogue took effect January 1, 2005, listing sectors in which foreign investment would be encouraged, restricted or prohibited, replacing the April 2002 list. Unlisted sectors are considered to be permitted.

Encouraged sectors include ones in which China could benefit from foreign assistance or technology, such as in the construction and operation of infrastructure facilities. In addition, the April 2002 catalogue had implemented elements of openings in sectors to which China committed in its WTO accession agreement, including for banking, insurance, petroleum extraction, value-added telecommunications, and distribution. The new catalogue opens television program production, distribution and movie production to foreign investors through allowing minority participation in joint ventures. It also adds certain component production for large-screen color projection tubes, automobile electronics, industrial boilers and production of compact disc media to the list of encouraged investments, which benefit from duty-free import of capital equipment and VAT rebates on inputs.

Over the past five years, China has also introduced various incentives for foreign investment in certain encouraged sectors. China introduced incentives for investments in high-technology industries, such as a regulation issued in November 1999 that provided foreign-invested enterprises a tax deduction for contributions to non-affiliated research and development or educational institutions. In December 2001, China announced comprehensive new incentives for investment in the less-developed central and western parts of the country.

The government also announced a series of measures in August 1999 that began to decentralize investment approval decision-making authority and to create new incentives for investments in key sectors and geographic regions. These guidelines allowed authorities at the provincial level of government to approve “encouraged” foreign-invested projects and raised the investment value at which central government approval is required.

Meanwhile, the Chinese government restricts foreign investment projects in sectors not in line with “the needs of China’s national economic development.” In these sectors, foreign firms must form a joint venture with a Chinese company and restrict their equity ownership to a minority share in order to invest in the Chinese market.

The Chinese government also prohibits investment in certain sectors. China bans investment in the news media and broadcast citing national security interests. The production of arms and the mining and processing of certain minerals remain prohibited sectors. U.S. investors have expressed particular concerns about China’s prohibition of investment in production and development of genetically modified plant seeds.

China is scheduled to release its 11th Five-Year Plan in mid-2005. The plan will outline policy objectives for the economy through 2010.

FOREIGN TRADE BARRIERS

Other Investment Issues

Venture Capital

Regulations that took effect in March 2003 replaced earlier provisional regulations permitting the establishment of foreign-invested venture capital firms, including wholly foreign-owned enterprises, aimed at funding high-technology and new technology startups in industries open to foreign investment. The regulations lower capital requirements, allow these firms to manage funds directly invested from overseas, and offer the option of establishing venture capital firms under an organizational form similar to the limited liability partnerships used in other countries. April 2001 regulations bar securities firms (including foreign-invested firms) from the private equity business, while foreign private equity firms are permitted subject to limits on corporate structure, share issuance and transfers, and investment exit options. Investment exit problems, especially the difficulty of listing on China's stock exchanges, coupled with the bureaucratic approvals required to list overseas, have limited interest in establishing China-based venture capital and private equity investment. As a result, most foreign venture capital and private equity investments in China are actually housed in offshore investment entities, which, as with other offshore FDI, can be transferred without Chinese government approval.

Holding Companies

There has been some relaxation of restrictions on the scope and operations of holding companies, although minimum capital requirements normally make them suitable only for corporations with several sizeable investments to manage. Holding companies may manage human resources across their affiliated companies and provide certain market research and other services to their affiliates. However, some restrictions on services provided by holding companies and on their financial operations and their ability to balance foreign exchange internally will remain even after full implementation of China's WTO commitments. Profit and loss consolidation within holding companies also remains prohibited.

Access to Capital Markets

Foreign-invested enterprises in China remain largely unable to access domestic and international stock markets, to sell corporate bonds, to accept venture capital investment, to sell equity, or to engage in normal merger, acquisition and divestment activity. Foreign exchange transactions on the capital account can be concluded only with case-by-case official review, and approvals are subject to very tight regulatory control. These barriers to capital market access were not addressed by China's WTO accession agreement. China has begun to experiment with liberalization, such as the opening of domestic stock markets to listings by foreign-invested firms. Through the Qualified Foreign Institutional Investor (QFII) program, foreign securities firms can gain limited access to the RMB-denominated A share market by applying for QFII status with the Chinese government. As of December 2004, 27 foreign firms had been granted QFII status, and 24 of them had been issued QFII investment quotas totaling \$3.425 billion.

FOREIGN TRADE BARRIERS

GOVERNMENT PROCUREMENT

In accordance with the terms of its WTO accession agreement, China agreed to conduct its government procurement in a transparent manner and to provide all foreign suppliers with equal opportunity to participate in procurements opened to foreign suppliers. China also committed to become an observer to the WTO Agreement on Government Procurement (GPA), which it did in May 2002, and to table an offer and initiate negotiations for membership in the GPA “as soon as possible.” In late 2003, MOF reportedly established a working group to study the possibility of initiating negotiations for accession to the GPA. In the interim, China agreed that all of its central and local government entities would conduct their procurements in a transparent manner, as reflected in its WTO accession agreement. China also agreed that, if a procurement were opened to foreign suppliers, it would provide MFN treatment by allowing all foreign suppliers an equal opportunity to participate in the bidding process.

In July 2002, China promulgated its first Government Procurement Law. In part, this was a response to the need to separate purchases by “state-owned enterprises,” which China had agreed in its WTO accession agreement would be made on a commercial basis, from “government procurement.” China also agreed that the government would not influence the commercial decisions of state-owned enterprises, although in practice this has not consistently been the case.

The Government Procurement Law, which became effective on January 1, 2003, attempts to follow the spirit of the GPA and incorporates provisions from the United Nations Model Law on Procurement of Goods. However, the law also directs central and sub-central government entities to give priority to “local” goods and services, with limited exceptions. China envisions that this law will improve transparency, reduce corruption and lower government costs. The 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. In August 2004, MOF issued implementing rules stipulating that procurement of foreign goods, works and services, which are allowed in exceptional circumstances, are subject to review and approval by MOF.

In August 2004, MOF issued measures covering bidding procedures, publication of information and the handling of complaints related to government procurements. The bidding rules require all government procurements over a certain amount to be conducted through public bidding. According to the 2004 catalog for central-government financed government procurement, the threshold for public bidding is RMB 1.2 million, or \$146,000. To be eligible to participate, suppliers must be domestic and provide “domestic goods and services.” MOF is reportedly formulating the criteria for “domestic goods and services.” The information publication rules require procuring entities and their agencies to make public all necessary information through media outlets designated by MOF. These rules define this information as statutes, data and other materials concerning government procurements, and also require the disclosure of detailed information concerning bid invitations and bidding. The complaint handling rules require MOF and local finance administrations to respond to complaints from suppliers regarding the conduct

FOREIGN TRADE BARRIERS

of procurements. Suppliers may apply for administrative review of a ruling or file an administrative suit in court.

Draft implementing rules governing the procurement of software products and services are of serious concern to U.S. companies. As initially drafted in 2003, when China's overall software market totaled \$3.3 billion and was projected to grow by more than 50 percent annually, these rules reportedly contained guidelines mandating that central and local governments should purchase software developed in China to the extent possible. In November 2004, MOF and MII released a partial summary of draft measures that appear to define "domestic software" very restrictively and, as a result, would make it difficult for foreign software to qualify for a procurement. The United States has raised serious concerns about this aspect of the draft measures. By the end of 2004, final measures had not yet been issued.

ELECTRONIC COMMERCE

China has experienced dramatic growth in Internet usage since 1999. According to the 15th semiannual Internet survey recently published by the China Internet Network Information Center (CNNIC), the number of people in China with access to the Internet was approximately 94 million, an increase of 18 percent year on year, second only to the United States in terms of total users. Falling personal computer prices and the arrival of devices tailored for the Chinese market will further expand Internet access.

China has also experienced a dramatic increase in the number of electronic businesses established. An estimated 78 percent of all Chinese websites are now operated by "enterprises" and 5 percent by "businesses." By the end of June 2004, there were roughly 626,600 registered websites in China. Of this total, 382,216 were registered under ".cn". However, despite these developments, only 11 percent of Chinese "enterprise" websites and 45 percent of Chinese "business" websites offer "e-commerce services." Nevertheless, China is experiencing rapid development of on-line business such as search engines, network education, on-line advertisements, audio-video service, paid e-mail, short message, on-line job hunting, Internet consulting and on-line gaming.

The Chinese government recognizes the potential of electronic commerce to promote exports and increase competitiveness and has made some progress toward establishing a viable commercial environment. However, some Chinese ministries with responsibility for electronic commerce have excessively regulated the Internet, thereby stifling the free flow of information and the consumer privacy needed for electronic commerce to flourish. Content is still controlled and encryption regulated, as discussed more fully above (in the "Regulation of Internet Content and Restrictions on Encryption and Decryption" section).

A number of technical problems also inhibit the growth of electronic commerce in China. Rates charged by government-approved Internet service providers make Internet access expensive for most Chinese citizens. Slow connection speeds are another problem, although this is changing as

FOREIGN TRADE BARRIERS

broadband connections become more readily available. In 2004, nearly 46 percent of China's Internet users had broadband connections, representing an increase of 146 percent over 2003, and China Telecom is now reportedly the world's largest DSL operator, with subscribers expected to exceed 10 million in 2004.

Other impediments to Chinese businesses and consumers conducting online transactions include the paucity of credit payment systems, consumer reluctance to trust online merchants, the lack of secure online payment systems and inefficient delivery systems. China has also yet to develop a legal framework conducive to the rapid growth of electronic commerce. Laws recognizing the validity of "e-contracting" tools and stressing the importance of online privacy and security have been proposed, but not yet issued. Despite these obstacles, however, over 40 percent of Chinese Internet users surveyed in June 2003 said they had made an online purchase within the past year, and almost a third of them said they had paid online.

In a positive sign, China passed E-signature legislation on August 28, 2004, which will become effective on April 1, 2005. China is also in the process of drafting data privacy legislation.

ANTICOMPETITIVE PRACTICES

China continues to struggle with economic inefficiencies and investment disincentives created by local protectionism, pricing practices and preservation of industry-wide monopolies. Anticompetitive practices in China take several forms. In some cases, industrial conglomerates operating as monopolies, near monopolies, or authorized oligopolies (as in the telecommunications industry) have been allowed to fix prices, allocate contracts, and in other ways restrict competition among domestic and foreign suppliers. Regional protectionism by provincial or local authorities often blocks efficient distribution of goods and services inside China. These practices may restrict market access for certain imported products, raise production costs, and restrict market opportunities for foreign-invested enterprises in China.

There are several existing laws and regulations in China addressing competition matters. However, these measures are largely ineffective due to poor national coordination and inconsistent local and provincial enforcement. China is drafting a new anti-monopoly law that could be adopted as early as mid-to-late 2005.

Since November 2002, foreigners have been able to purchase traded and non-traded (designated state) shares of Chinese enterprises. In addition, regulations that took effect in April 2003 specify procedures for foreign acquisition of and merger with domestic enterprises. These regulations require pre-merger notification and allow for examination of antitrust considerations in some cases. By requiring approval of all owners of the domestic enterprise, the regulation implicitly prohibits hostile takeovers. The thresholds for notification are not straightforward, leaving open the possibility of abuse by officials or domestic competitors. Domestic competitors have the power under the regulations to call for public hearings on prospective mergers.

FOREIGN TRADE BARRIERS

China also issued provisional regulations in November 2002, effective January 2003, on using foreign investment to reorganize state-owned enterprises. These reorganizations, however, require extensive approvals and full agreement of the domestic enterprise's labor union. These requirements are likely to limit the appeal of this type of investment.

OTHER BARRIERS

Transparency

Laws and regulations directly affecting international trade are increasingly becoming publicly available in China. Since 1992, China has published all trade laws and regulations in the "MOFCOM Gazette," available on a subscription basis, and MOFCOM maintains an updated list on its website. However, many measures that do not rise to the level of ministry-issued regulations or implementing rules continue to remain unavailable to the public. China's ministries routinely implement policies based on internal "guidance" or "opinions" that are not available to foreign firms. Experimental or informal policies and draft regulations, in addition, are regarded as internal matters and public access is tightly controlled.

China, in its WTO accession agreement, committed to publishing all laws, regulations and other measures that relate to trade matters, including those that affect imports, and generally to allowing its WTO trading partners an opportunity to comment on them before implementation. China also agreed to provide a copy of new trade-related laws, regulations and other measures to the WTO Secretariat in Geneva, translated into one or more of the WTO's official languages (English, French and Spanish) no later than 90 days after implementation. China further agreed to create various enquiry points for its WTO trading partners and foreign businesses to obtain information about these measures.

Various government-owned specialty newspapers routinely carry the texts of government regulations, implementing rules, circulars and announcements. Many government ministries also publish digests or gazettes containing the texts of these measures, both in written form and on their websites. In addition, there has been a proliferation of online news and information services that routinely offer up-to-date news about and texts of new laws and regulations. Some services even provide legal-quality English translations by subscription.

While positive in some respects, the sheer number of outlets through which these measures are published complicates the ability of interested parties to track their development and issuance. In its WTO accession agreement, China agreed to establish or designate an official journal for the publication of trade related measures. In late 2002, China designated the China Foreign Economic and Trade Gazette as the official journal for this purpose. Published by MOFCOM and replacing the MOFCOM Gazette, it came out on a trial basis in October 2002 and as an official publication in January 2003. However, this journal does not carry draft rules for comment, nor does it consistently carry trade related measures developed by ministries and

FOREIGN TRADE BARRIERS

agencies other than MOFCOM. The establishment or designation of a single comprehensive journal would enhance the ability of WTO members to track the drafting, issuance and implementation of trade related measures. Furthermore, 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 December 2001, the State Council issued regulations explicitly allowing comment periods and hearings. However, many of China's ministries and agencies continued to follow the practice prior to China's accession to the WTO. The ministry or agency drafting a new or revised law or regulation will normally consult with and submit drafts to other ministries and agencies, Chinese experts and affected Chinese companies. At times, it will also consult with select foreign companies, although it will not necessarily share drafts with them. As a result, only a small proportion of new or revised laws and regulations have been issued after a period for public comment, and even in these cases the amount of time provided for public comment has generally been 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. For example, China issued several major trade-related laws and regulations in 2004, including a revised Foreign Trade Law, insurance regulations, government procurement regulations and several sets of implementing rules, a new automobile industrial policy, regulations on rules of origin for imports and exports, and customs regulations on administrative penalties for IPR infringement. Encouragingly, drafts of the insurance regulations and most of the government procurement measures were circulated for public comment. However, drafts of the Foreign Trade Law, the automobile industrial policy, the rules of origin regulations, and the customs regulations were either selectively circulated or not circulated at all. Toward the end of 2004, a number of important measures, including direct selling regulations and government software procurement implementing rules were close to being finalized, without having been circulated for public comment.

U.S. industry continues to report instances where Chinese companies are provided unofficial guidance by Chinese regulators, guidance which is usually unavailable to foreign entities. In some cases, Chinese officials provided unpublished documents to interested parties, but this dissemination was ad hoc and based more on personal connections than formal procedures.

MOFCOM's predecessor, MOFTEC, in late 2001, established an enquiry point to provide information on new trade and investment laws, regulations and other measures. It is not clear whether this enquiry point is still functioning, however. 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 them to be responsive and helpful, and have generally received timely replies.

FOREIGN TRADE BARRIERS

Legal Framework

Laws and Regulations

Laws and regulations in China tend to be more general and ambiguous than in other countries. While this approach allows the Chinese authorities to apply laws and regulations flexibly, it also results in inconsistency and confusion in application. Companies often have difficulty determining whether their activities contravene a particular law or regulation.

In China, regulations are also promulgated by a host of different ministries and governments at the central, provincial and local levels, and it is not unusual for the resulting regulations to be at odds with each other. Even though finalized regulations are now routinely published in China, they often leave room for discretionary application and inconsistencies, either through honest misunderstanding or by design. Indeed, government bureaucracies have sometimes been accused of selectively applying regulations. China has many strict rules that are often ignored in practice until a person or entity falls out of official favor. Governmental authorities can wield their discretionary power to “crack down” on foreign or disfavored investors or make special demands on such investors simply by threatening to wield such power.

This lack of a clear and consistent framework of laws and regulations can be a barrier to the participation of foreign firms in the Chinese domestic market. A comprehensive legal framework, coupled with adequate prior notice of proposed changes to laws and regulations, and an opportunity to comment on those changes, would greatly enhance business conditions, promote commerce and reduce opportunities for corruption. The U.S. Government has provided technical assistance, at the central and local levels of government in China, in an effort to promote improvements in China’s legislative and regulatory drafting process.

In its WTO accession agreement, China committed to establish tribunals for the review of all administrative actions relating to the implementation of trade-related laws, regulations, judicial decisions and administrative rulings. 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. China also committed, at all levels of government, to apply, implement and administer all of 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 connection with this commitment, 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. The actual workings of this mechanism still remain unclear, however.

Commercial Dispute Resolution

Both foreign and domestic companies often avoid seeking enforcement actions through the Chinese courts, as skepticism about the independence and professionalism of China's court system and the enforceability of court judgments and awards remains high. There is a widespread perception that judges, particularly outside of China's big cities, are subject to influence by local political or business pressures. Most judges are not trained in the law and/or lack higher education, although this problem decreases at the higher levels of the judiciary.

At the same time, the Chinese government is moving to establish consistent and reliable mechanisms for dispute resolution through the adoption of improved codes of ethics for judges and lawyers and increased emphasis on the consistent and predictable application of laws. The Judges' Law, issued by the Standing Committee of the National People's Congress in 1995, requires judges to have degrees in law or in other subjects where they have acquired specialized legal knowledge, and permits judges appointed before the law's implementation who do not meet such standards to undergo necessary training. 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. In August 2002, the Supreme People's Court issued rules designating certain higher-level courts to hear cases involving administrative agency decisions relating to international trade in goods or services or intellectual property rights. According to the Supreme People's Court, China's more experienced judges sit on the designated courts, and the geographic area under the jurisdiction of each of these designated courts has been broadened in an attempt to minimize local protectionism. The rules provide that foreign (or Chinese) enterprises and individuals may bring lawsuits in the designated courts raising challenges, under the Administrative Litigation Law, to decisions made by China's administrative agencies relating to international trade matters. The rules also state that when there is more than one reasonable interpretation of a law or regulation, the courts should choose an interpretation that is consistent with the provisions of international agreements to which China has committed, such as the WTO rules. The rules took effect in October 2002.

Despite initial enthusiasm, foreign observers have grown increasingly skeptical of the China International Economic and Trade Arbitration Commission (CIETAC) as a forum for the arbitration of trade disputes. Some foreign firms have obtained satisfactory rulings from CIETAC but other firms and legal professionals have raised concerns about restrictions on the selection of arbitrators and inadequacies in procedural rules necessary to ensure thorough, orderly and fair management of cases.

Finally, in cases where the judiciary or arbitration panels have issued judgments in favor of foreign-invested enterprises, enforcement of the judgments has often been difficult. Officials responsible for enforcement are often beholden to local interests and unwilling to enforce court judgments against locally powerful companies or individuals.

Labor Issues

In recent years, China has expanded the scope of its national labor laws and regulations so they now cover most, though not all, key labor areas. Even with these changes, China does not adhere to certain internationally recognized labor standards, such as the rights of freedom of association and collective bargaining. In addition, critics allege that China's household registration system is equivalent to a form of forced or compulsory labor, and there are many reports indicating that China does not enforce its laws and regulations concerning minimum wages, hours of work and occupational safety and health. There are also persistent concerns about the use of prison labor and child labor.

The Chinese government is slowly developing nationwide pension, unemployment insurance, medical insurance and workplace injury insurance systems that require substantial employer contributions. These systems are still rudimentary and characterized by serious funding shortfalls, in part due to widespread non-compliance among domestic firms. There is also inconsistent application and enforcement of labor regulations between Chinese-owned enterprises and foreign-invested enterprises.

The cost of labor, especially unskilled labor, is low in much of China. The existence of a large pool of surplus rural workers, many of whom seek work in urban areas, helps to keep unskilled wages low. Some companies offering substandard wages and working conditions have experienced shortages of unskilled labor. Where competition for workers is intense and the supply limited, as in the case of technical, managerial and professional staff in China's coastal areas, wages can be higher. However, restrictions on labor mobility distort labor costs. China is gradually easing restrictions under the country's household registration system, which has traditionally limited the movement of workers within the country, in part due to the recognition that labor mobility is essential to the continued growth of the economy.

Corruption

Many people expected that China's entry into the WTO, which mandated a significant reduction in tariffs, would in turn reduce incentives for smuggling-related corruption. While WTO membership has increased China's exposure to international best practices and resulted in some overall improvements in transparency, corruption remains endemic. Chinese officials themselves admit that corruption is one of the most serious problems the country faces, and China's new leadership has called for an acceleration of the country's anti-corruption drive with a focus on closer monitoring of provincial-level officials. According to Chinese state media sources, in 2004, Chinese prosecutors caught more than 42,000 officials for corruption and other offenses, reflecting a rise of one percent from 2003. Official graft was a leading offense, with prosecutors recovering a total of RMB 3.8 billion (\$460 million) of misappropriated and embezzled funds.

In July 2004, China implemented a new Administrative Licensing Law. This law should increase transparency in the licensing process, an area that has long served as a source of official

FOREIGN TRADE BARRIERS

corruption. This law seeks to ensure the reasonable use of administrative licensing powers, to protect the interests of corporations and individuals, and to promote efficient administrative management by requiring government agencies to set up special offices for issuing licenses and to respond to applications within 20 days. It is too early to judge the effectiveness of this law, but some reports suggest that it has already resulted in the removal of numerous unnecessary administrative licensing requirements.

China issued its first law on unfair competition in December 1993, and the Chinese government continues to call for improved self-discipline and anti-corruption initiatives at all levels of government. While the government has pledged to begin awarding contracts solely on the basis of commercial criteria, it is unclear how quickly and to what extent the government will be able to follow through on this commitment. U.S. suppliers complain that the widespread existence of unfair bidding practices in China puts them at a competitive disadvantage. This dilemma is less severe in sectors where the United States holds clear technological or cost advantages. Corruption nevertheless undermines the long-term competitiveness of both foreign and domestic entities in the Chinese market.

Land Issues

China's constitution specifies that all land is owned in common by all the people. In practice, agricultural collectives, under the firm control of local Communist Party chairmen, distribute agricultural land to the rural poor, while city governments distribute land for residential and industrial use. The State and collectives can either "grant" or "allocate" land use rights to enterprises in return for payment of fees. Enterprises granted land-use rights are guaranteed compensation if the State asserts eminent domain over the land, while those with allocated rights are not. Granted land-use rights cost more, of course, than allocated rights. However, the law does not define standards for compensation when eminent domain supercedes granted land-use rights. This situation creates considerable uncertainty when foreign investors are ordered to vacate. The absence of public hearings on planned public projects, moreover, can give affected parties, including foreign investors, little advance warning.

The time limit for land-use rights acquired by foreign investors for both industrial and commercial enterprises is 50 years. A major problem for foreign investors is the array of regulations that govern their ability to acquire land-use rights. Local implementation of these regulations may vary from central government standards, and prohibited practices may occur in one area while they are enforced in another. Most wholly-owned foreign enterprises seek granted land-use rights to state-owned urban land as the most reliable protection for their operations. Chinese-foreign joint ventures usually attempt to acquire granted land-use rights through lease or contribution arrangements with the local partners.

China's current rural land law, which took effect in 2003, gives peasants fixed contracts for periods of 30 to 50 years, and permits peasants to exchange or rent out their land-use rights while their use contract remains in force. There is no immediate prospect for changing from land-use

FOREIGN TRADE BARRIERS

rights to direct ownership of rural land. However, in 2004, the leadership has pressed for sturdier land rights for farmers along with stricter controls over the legal process for converting farmland from agricultural to industrial or residential use. Local governments are no longer supposed to expropriate land for commercial use, as farmers are now supposed to be able to negotiate a compensation price for land directly with commercial users. However, implementation of these provisions lags.