# 2004 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE

United States Trade Representative

# 2004 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE

**December 11, 2004**

**United States Trade Representative**

# TABLE OF CONTENTS


| | Page |
|---|---|
| FOREWORD | 1 |
| EXECUTIVE SUMMARY | 3 |
| BACKGROUND | 9 |
| China's WTO Accession Negotiations | 9 |
| Overview of China's WTO Commitments | 9 |
| STATUS OF CHINA'S WTO COMPLIANCE EFFORTS | 11 |
| Trading Rights and Distribution Services | 11 |
| *Trading Rights* | 11 |
| *Distribution Services* | 14 |
| Import Regulation | 21 |
| *Tariffs* | 21 |
| *Customs and Trade Administration* | 22 |
| *Non-tariff Measures* | 26 |
| *Tariff-rate Quotas on Industrial Products* | 27 |
| *Other Import Regulation* | 28 |
| Export Regulation | 32 |
| Internal Policies Affecting Trade | 34 |
| *Non-discrimination* | 34 |
| *Taxation* | 36 |
| *Subsidies* | 38 |
| *Price Controls* | 39 |
| *Standards, Technical Regulations and Conformity Assessment Procedures* | 40 |
| *Other Internal Policies* | 45 |
| Investment | 47 |
| Agriculture | 49 |
| *Tariffs* | 51 |
| *China's Biotechnology Regulations* | 52 |
| *Tariff-rate Quotas on Bulk Agricultural Commodities* | 53 |
| *Sanitary and Phytosanitary Issues* | 55 |
| *Inspection-related Requirements* | 56 |
| *Export Subsidies* | 58 |

# TABLE OF CONTENTS (cont'd)

Page

**Intellectual Property Rights** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 58
*Legal Framework* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 60
*Enforcement* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 62
**Services** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 67
*Financial Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 69
*Legal Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 74
*Telecommunications* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 75
*Express Delivery Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 76
*Construction and Related Engineering Services* . . . . . . . . . . . . . . . 78
*Aviation Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 79
*Maritime Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 79
*Other Services* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 80
**Legal Framework** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 80
*Transparency* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 81
*Uniform Application of Laws* . . . . . . . . . . . . . . . . . . . . . . . . . . . . 83
*Judicial Review* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 84

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

**APPENDIX 2** (List of Witnesses)

## FOREWORD

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

Like the prior reports, this report is structured as an examination of the nine broad categories of WTO commitments undertaken by China. Throughout the report, USTR has attempted to provide as complete a picture of China's WTO compliance as possible, subject to the inherent constraints presented by the sheer volume and complexity of the required changes to China's trade regime and transparency obstacles. USTR notes areas where progress has been achieved and underscores shortcomings as appropriate, not only with regard to the commitments that became effective upon China's accession, but also the commitments scheduled to be phased in during this past year.

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

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

To aid in its preparation of this report, USTR also published a notice in the Federal Register on July 29, 2004, asking for written comments and testimony from the public and scheduling a public hearing before the TPSC, which took place on September 23, 2004. A list of the written submissions received from interested parties is set forth in Appendix 1, and the persons who testified before the TPSC are identified in Appendix 2.

## EXECUTIVE SUMMARY

The publication of this Report marks three years since China's accession to the WTO on December 11, 2001. That event was in many ways the culmination of two decades of economic reform that saw China move from a strict command economy to one in which market forces have played an increasing role. Through an accession agreement founded on the key WTO principles of market access, non-discrimination, national treatment and transparency, China committed to overhaul its trade regime and, more fundamentally, to open its market to greater competition.

The United States and other WTO members negotiated with China for 15 years over the specific terms pursuant to which China would enter the WTO. As a result of those negotiations, China agreed to extensive, far-reaching and often complex commitments to change its trade regime, at all levels of government. China committed to implement a set of sweeping reforms that required it to lower trade barriers in virtually every sector of the economy, provide national treatment and improved market access to goods and services imported from the United States and other WTO members, and protect intellectual property rights (IPR). China also agreed to special rules regarding subsidies and the operation of state-owned enterprises, in light of the state's large role in China's economy. In accepting China as a fellow WTO member, the United States also secured a number of significant concessions from China that protect U.S. interests during China's WTO implementation stage. Implementation should be substantially completed – if China fully adheres to the agreed schedule – by December 11, 2007. By contrast, the United States did not make any specific new concessions to China, other than simply to agree to accord China the same treatment it accords the other 146 members of the WTO.

China deserves due recognition for the tremendous efforts made to reform its economy to comply with the requirements of the WTO. It is beyond the scope of this Report, however, to detail all the ways in which China is in compliance with its commitments. This Report sets out to reflect the significant concerns raised by U.S. stakeholders regarding China's efforts to implement its WTO commitments and China's adherence to WTO rules. As the Report shows, while China's efforts to fulfill its WTO commitments are impressive, they are far from complete and have not always been satisfactory, and China at times has demonstrated difficulty in adhering to WTO rules.

As described in our 2002 Report, the first year of China's WTO membership saw significant progress, as China took steps to repeal, revise or enact more than one thousand laws, regulations and other measures to bring its trading system into compliance with WTO standards. However, that year also saw uneven implementation of many of China's WTO commitments.

In the 2003 Report, we concluded that China's WTO implementation efforts had lost a significant amount of momentum, and we identified numerous specific WTO-related problems. As those problems mounted in 2003, the Administration responded by stepping up its efforts to engage China's senior leaders. The Administration's efforts culminated in December 2003, when President Bush and China's Premier, Wen Jiabao, 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. Premier Wen also committed separately to facilitate the increase of U.S. exports to China.

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, 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.

In July 2004, the United States was able to successfully resolve the first-ever dispute settlement case brought against China at the WTO. In that case, the United States, with support from four other WTO members, had challenged discriminatory value-added tax (VAT) policies that favored Chinese-produced semiconductors over imported semiconductors. The United States also effectively used other mechanisms at the WTO throughout the year, including the transitional review process for China, to draw attention to a variety of areas where China needed to make progress.

U.S. stakeholders were significantly more satisfied with China's WTO performance in 2004 than in the previous two years. For example, in September 2004, two U.S. trade associations representing many U.S. businesses doing business in China explained in a written submission:

> It has been a good year for American companies in China . . . . We believe China is now substantially in compliance with its [WTO] obligations – a marked improvement over last year.

At the same time, U.S. exports to China continued to increase dramatically in 2004, as they have done in every year since China joined the WTO. U.S. exports to China totaled $35 billion for the most recent twelve-month period, more than double the total for 2001. In fact, from 1999 to 2004, U.S. exports to China increased nearly ten times faster than U.S. exports to the rest of the world. As a result, China has risen from our 11th largest export market five years ago to our fifth largest export market today.

The reports from the private sector and improved export statistics are heartening. Nevertheless, serious problems remain, and new problems regularly emerge. Most seriously, China's

implementation of its WTO commitments has lagged in many areas of U.S. competitive advantage, particularly where innovation or technology play a key role.

The areas of particular concern to the United States are summarized below.

**Intellectual Property Rights**

Upon joining the WTO, China agreed to overhaul its legal regime to ensure the protection of intellectual property rights in accordance with the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). China has undertaken substantial efforts in this regard, as it has revised or adopted a wide range of laws, regulations and other measures. While some problems remain, China did a relatively good job of overhauling its legal regime.

However, China has been much less successful in ensuring effective IPR protection, as IPR enforcement remains problematic. Indeed, 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. One U.S. trade association reports that counterfeiting and piracy rates in China remain among the highest in the world, exceeding 90 percent for virtually every form of intellectual property.

The Administration places the highest priority on improving the protection of IPR in China. At the April 2004 JCCT meeting, in response to concerns raised by the United States, Vice Premier Wu 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 Administration is monitoring implementation of this action plan closely and will conduct an out-of-cycle review early next year under the Special 301 provisions of U.S. trade law to assess China's implementation of its IPR commitments. The Administration has called on U.S. companies to submit a range of information to enhance its monitoring of China's enforcement efforts in every industry and in all regions of China. In addition, the Administration has taken comprehensive action – under the Strategy Targeting Organized Piracy (STOP!) – to block trade in counterfeit and pirated goods, regardless of their origin. The Administration 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 TRIPS Agreement.

**Trading Rights and Distribution Services**

Of key importance during 2004 was China's implementation of its commitments to full liberalization of trading rights and distribution services, including wholesaling services, commission agents' services, retail services and franchising services, as well as related services. As agreed at the JCCT meeting in April 2004, China implemented its trading rights commitments nearly six months ahead of schedule, permitting companies and individuals to import and export

goods in China directly without having to use a middleman. China is scheduled to implement its distribution services commitments by December 11 of this year and thereby allow foreign enterprises to freely distribute goods within China. While China has issued regulations that call for timely implementation of these commitments, China has not made clear the precise means by which foreign enterprises will actually be able to apply for approval to provide any of the various types of distribution services. In addition, China has not yet fulfilled its commitment to open its market for sales away from a fixed location, or direct selling, by December 11, 2004, as none of the measures necessary to allow foreign participants have been issued. The Administration will pay particular attention to these areas over the coming months to ensure that China fully meets these important WTO commitments.

**Services**

The United States enjoys a substantial surplus in trade in services with China, and the market for U.S. service providers in China is increasingly promising. However, the expectations of the United States and other WTO members when agreeing to China's commitments to open China's service sectors have not been fully realized in all sectors. Indeed, through an opaque regulatory process, overly burdensome licensing and operating requirements, and other means, Chinese regulatory authorities continue to frustrate efforts of U.S. providers of insurance, express delivery, telecommunications and other services to achieve their full market potential in China. At the April 2004 JCCT meeting, China committed to abandon problematic proposed express delivery restrictions and to resume a dialogue on insurance issues, although it has been slow to follow through on these commitments.

**Agriculture**

With U.S. agricultural exports totaling $5.4 billion in 2003, China has become one of the fastest growing overseas markets for U.S. farmers. U.S. soybeans, cotton and other agricultural commodities have found ready customers in China, largely fulfilling the potential recognized by U.S. negotiators during the years leading up to China's WTO accession.

Despite the impressive export figures, China's WTO implementation in the agricultural sector is beset by uncertainty. 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. Like all commodity markets, agricultural trade requires as much predictability and transparency as possible in order to reduce the already substantial risks involved and preserve margins. Agricultural trade with China, however, remains among the least transparent and predictable of the world's major markets.

In 2004, the United States was able to make substantial headway on a number of key issues in agricultural trade, particularly in the area of biotechnology approvals and the removal of problematic sanitary and phytosanitary measures that had been curtailing trade. Given past

experiences, however, maintaining and improving China's adherence to WTO rules in the area of agriculture will require continued high-level attention in the months and years to come.

**Industrial Policies**

Since acceding to the WTO, China has increasingly resorted to 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.

Prime examples of these industrial policies in 2004 included China's discriminatory semiconductor VAT policies, China's efforts to promote unique Chinese standards for wireless encryption and third generation (3G) wireless telephony and, more recently, a government procurement policy that mandates purchases of Chinese-produced software. These are among an array of steps that China has taken to encourage or coerce technology transfer or the use of domestic content across many sectors. Some of these policies stray dangerously close to conflict with China's WTO commitments in the areas of market access, national treatment and technology transfer.

In 2004, the United States and China made important progress toward resolving conflicts over a number of these and other industrial policies, such as China's export restrictions on coke. However, more work needs to be done, and the advent of new or similar policies in the future will require continued vigilance by the United States and other WTO members.

**Transparency**

The foundation of WTO compliance is transparency, which permits markets to function effectively and reduces opportunities for officials to engage in trade-distorting practices behind closed doors. China has not traditionally operated according to the WTO's transparency principles, and thus its commitments in this area in many ways represent a profound historical shift. By that scale, China has come a great distance toward achieving transparency in its official decision-making and regulatory regimes. Indeed, in the last several years, China has made important strides to improve transparency across a wide range of national and provincial authorities. China's Ministry of Commerce (MOFCOM) is most notable for its impressive moves toward adopting WTO transparency norms. However, many other ministries and agencies have made less than impressive efforts to improve their transparency. As a result, China's 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.

**Conclusion**

Most of China's key commitments – including trading rights and distribution services – were scheduled to be phased in fully by December 11, 2004. This coming year – 2005 – will therefore provide a critical glimpse at what to expect of China as a WTO member once its full range of commitments are in place.

In 2005, the Administration will continue to be relentless in its efforts to ensure China's full compliance with its WTO commitments, with particular emphasis on ensuring effective protection of U.S. patents, trademarks and copyrights in China. This work will be facilitated by additional funding from the Congress in 2004 that has allowed USTR and other agencies to increase their level of engagement and enforcement vis-à-vis China. With this additional funding, USTR established a separate office focused solely on China trade issues and doubled the resources devoted to those issues, while other agencies increased staffing levels in Washington and Beijing.

As in 2004, the Administration is committed to working with China to ensure that all of the benefits of China's WTO membership are fully realized by U.S. workers, businesses, farmers, service providers and consumers. The Administration is also committed to working with China to resolve problems in our trade relationship before they become broader bilateral irritants. When this process is not successful, however, the Administration will not hesitate to employ the full range of dispute settlement and other tools available through China's WTO accession agreement. At the same time, the Administration will continue to strictly enforce its trade laws to ensure that U.S. interests are not harmed by unfair trade practices.

# BACKGROUND

## China's WTO Accession Negotiations

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

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

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

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

## Overview of China's WTO Commitments

In order to accede to the WTO, China had to agree to take concrete steps to remove trade barriers and open its markets to foreign companies and their exports from the first day of accession in virtually every product sector and for a wide range of services. Supporting these

steps, China also agreed to undertake important changes to its legal framework, designed to add transparency and predictability to business dealings.

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

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

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

# STATUS OF CHINA'S WTO COMPLIANCE EFFORTS

## Trading Rights and Distribution Services

### *Trading Rights*

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

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

After falling behind in 2002 and 2003 on its commitments to begin phasing in trading rights, China took important steps in 2004. China agreed, at the April 2004 JCCT meeting, to implement its trading rights commitments in full by July 1, 2004, nearly six months ahead of the schedule established in its WTO accession agreement. China subsequently followed through on this agreement, as described below.

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

In its accession agreement, responding to concerns raised by members of the WTO working party on China's accession, China committed to substantial liberalization in the area of trading rights. China committed to eliminate its system of examination and approval of trading rights and make full trading rights automatically available for all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships,

within three years of its accession, or by December 11, 2004, the same deadline for China to eliminate most restrictions in the area of distribution services.

China had also committed to take a number of liberalization steps during the years prior to its adoption of an automatic trading rights system. China committed that, immediately upon its accession to the WTO (on December 11, 2001), it would no longer condition eligibility for trading rights on export performance, trade balancing, foreign exchange balancing or prior experience requirements. China further committed to expand the availability of trading rights pursuant to an agreed schedule covering the first three years of its WTO membership. First, China committed that it would make trading rights available to Chinese enterprises immediately upon its accession, subject to certain minimum registered capital requirements, to be gradually decreased during the three-year transition period (ending December 11, 2004). The minimum registered capital was to be set at RMB 5 million ($603,000) on December 11, 2001, and then reduced to RMB 3 million ($362,000) one year later (December 11, 2002) and to RMB 1 million ($120,600) two years later (December 11, 2003) before being eliminated three years later (December 11, 2004). Second, China committed that it would make full trading rights available to joint ventures with minority foreign ownership beginning no later than one year after China's accession (or by December 11, 2002), except with regard to those goods still reserved for state trading under China's accession agreement. Third, China committed that it would make these same trading rights available to joint ventures with majority foreign ownership beginning no later than two years after China's accession (or by December 11, 2003).

China fully implemented its phase-in commitments insofar as they related to Chinese enterprises. With the issuance of the *Circular Concerning the Rules on the Administration of Import and Export Rights* by China's trade ministry (then known as the Ministry of Foreign Trade and Economic Cooperation, or MOFTEC, and renamed the Ministry of Commerce, or MOFCOM, following a government restructuring in mid-2003) in July 2001, and the issuance of the *Notice on the Rectification of Import and Export Qualification Standards and Verification Procedures* by MOFCOM in August 2003, China kept pace with the required reductions in the minimum registered capital requirement for Chinese enterprises to obtain trading rights. Currently, the minimum registered capital for Chinese manufacturing enterprises is RMB 0.5 million ($60,300), and the minimum registered capital for Chinese trading enterprises is RMB 1 million, except in the central and western regions, where the requirement was RMB 0.5 million.

Meanwhile, China fell behind in implementing its phase-in commitments insofar as they related to foreign-invested enterprises as soon as they began to mature one year after China's WTO accession. China did not make full trading rights available to all joint ventures with minority foreign ownership (as was required by December 11, 2002), nor did China subsequently make full trading rights available to all joint ventures with majority foreign ownership (as was required by December 11, 2003). Instead, well into 2004, China continued to limit the availability of trading rights by imposing conditions on the eligibility of these enterprises, including requirements related to minimum registered capital, import levels, export levels and prior experience. It was only in

mid-2004 that China finally began to take steps to implement its trading rights commitments more fully.

Foreign-invested manufacturing enterprises have had the right to import inputs for production purposes and the right to export their finished goods, without the need for prior approval, since well before China's accession pursuant to China's *Foreign Trade Law*. In January 2001, China expanded the import rights of some foreign-invested manufacturing enterprises with MOFTEC's issuance of the *Supplementary Provisions (2) to the Provisional Regulations Governing the Establishment of Investment-type Companies by Foreign Business Investment*. In July 2001, shortly before its accession, China granted limited additional export rights to some foreign-invested manufacturing enterprises with MOFTEC's issuance of the *Circular Concerning the Extension of Import and Export Rights for Foreign-Funded Enterprises*. Both of these measures, however, conditioned trading rights eligibility on requirements related to minimum registered capital, import levels, export levels and/or prior experience, among others.

China's treatment of foreign-invested enterprises seeking to operate as trading companies (rather than manufacturing companies) has been set forth in the *Provisional Rules for the Establishment of Chinese-Foreign Equity Joint Venture Foreign Trade Companies*, issued by MOFTEC in January 2003. These rules permitted the formation of foreign-invested trading enterprises (with minority foreign ownership immediately and majority foreign ownership after December 11, 2003), which may import and export all goods (except goods reserved for state trading), but only if certain stringent requirements are met. For example, the foreign investor must have had an average annual amount of trade with China of at least $30 million for the preceding three years (or $20 million if the foreign-invested trading enterprise registers in the central or western regions of China). Similar requirements applied to the Chinese investor. In addition, the foreign-invested trading enterprise must have had minimum registered capital of RMB 50 million ($6.03 million) and personnel experienced in conducting international trade.

As China fell behind in phasing in its trading rights commitments, the United States raised its concerns with China's restrictive treatment of foreign-invested enterprises in bilateral meetings throughout 2003, beginning with the Trade Dialogue meeting held in Beijing in February and including a series of high-level meetings later in the year and a second Trade Dialogue meeting in November. The United States urged China to take immediate steps to bring its regulations into compliance with its trading rights commitments. The United States and several other WTO members also raised these same concerns during the transitional reviews held by the WTO's Market Access Committee and Council for Trade in Goods in October and November 2003. As 2004 approached, the United States also pressed China on the importance of issuing, in a timely manner, final laws and regulations creating an automatic trading rights system for all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships, as required by December 11, 2004. The United States made trading rights one of its priority issues during the run-up to the April 2004 JCCT meeting.

In January 2004, the Legislative Affairs Commission of the National People's Congress circulated a draft of a revised *Foreign Trade Law* to select domestic and foreign business organizations for comment. This draft included provisions addressing China's trading rights commitments. Although not invited to comment, the United States submitted its own detailed written comments on the draft, seeking needed clarifications and revisions regarding the operation of the proposed registration process. In April 2004, the National People's Congress issued the final revised *Foreign Trade Law*. It made many of the clarifications and revisions requested by the United States and provided for trading rights to be automatically available through a registration process for all domestic and foreign entities and individuals, effective July 1, 2004, almost six months ahead of the scheduled full liberalization required by China's accession agreement. In May 2004, MOFCOM circulated a draft of implementing rules setting out the procedures for registering as a foreign trade operator and asked for public comment. MOFCOM issued the final implementing rules in June 2004, in time for the new registration process to be operational on the July 1 effective date.

U.S. companies have reported few problems with the new trading rights registration process. For many U.S. companies, however, having the right to trade – and, in particular, the right to import – will only become meaningful once China implements its related commitments to provide full liberalization of distribution services, scheduled for December 11 of this year.

***Distribution Services***

Prior to its WTO accession, China generally did not permit foreign enterprises to distribute products in China, i.e., to provide wholesaling, commission agents', retailing or franchising services or to provide related services, such as repair and maintenance services. In its accession agreement, China committed to eliminate national treatment and market access restrictions on foreign enterprises providing these services through a local presence within three years of China's accession (or by December 11, 2004), subject to limited product exceptions. In the meantime, China agreed to progressively liberalize its treatment of wholesaling services, commission agents' services and direct retailing services (except for sales away from a fixed location), as described below.

China's implementation efforts in this area were initially problematic. Immediately upon its WTO accession, 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 U.S. engagement during the run-up to the April 2004 JCCT meeting, that China began to take steps to liberalize. At that time, MOFCOM issued regulations eliminating national treatment and market access restrictions on joint ventures providing wholesaling services, commission agents' services, direct retailing services (other than sales away from a fixed location) and franchising services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004. However, MOFCOM's delay in clarifying the procedures for securing the necessary approval certificates, such as through the issuance of implementing rules, has so far prevented foreign enterprises from

providing these services. In addition, MOFCOM's delay in issuing regulations on sales away from a fixed location, or direct selling, has postponed the start-up of direct selling activities by foreign enterprises. These delays are disappointing, given the fundamentally important nature of China's distribution services commitments and the repeated assurances by senior-level Chinese government officials that China would implement these commitments on time.

Once the various approval systems become operational, the United States will closely monitor how MOFCOM and relevant provincial and local authorities exercise their approval authority. In particular, the United States will work to ensure that the approval systems operate expeditiously, in a non-discriminatory manner and without creating any new trade barriers.

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

The United States will also work to ensure that U.S. distribution companies do not face unwarranted barriers to the expansion of their activities in China. For example, the United States will monitor how MOFCOM and relevant provincial and local authorities apply a provision in the new distribution services regulations requiring wholesaling and retailing enterprises to comply with municipal commercial development rules. This provision would seem to reinforce the *Notice on Strengthening the Planning Work for Urban Commercial Networks*, issued by MOFTEC in January 2003. That notice had reiterated the requirement in an earlier measure that wholesaling joint ventures comply with the commercial development plans of the cities in which they are located. It also provided that cities that have not yet formulated urban commercial network plans must complete their work by December 2004 and in the interim cannot submit wholesaling joint venture applications for approval.

Wholesaling Services and Commission Agents' Services

China committed that, immediately upon accession, it would permit Chinese-foreign joint ventures and wholly foreign-owned enterprises to distribute goods that they make in China, without any market access or national treatment limitations. Within one year after accession (or by December 11, 2002), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents' services for almost all goods, whether made in China or imported, through joint ventures with minority foreign ownership. Excepted goods include salt, tobacco, chemical fertilizers, processed oil and crude oil as well as books, newspapers, magazines, pharmaceutical products, pesticides and mulching films. Within two years after accession (or by

December 11, 2003), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents' services through majority foreign-owned joint ventures, subject to the same exceptions. Within three years after accession (or by December 11, 2004), China agreed to permit foreign service suppliers to supply wholesaling services and commission agents' services through wholly foreign-owned enterprises. In addition, by this time, the exceptions for books, newspapers, magazines, pharmaceutical products, pesticides and mulching films are to be eliminated. The exceptions for chemical fertilizers, processed oil and crude oil (but not salt and tobacco) are to be eliminated within five years after accession (or by December 11, 2006).

China did not have to take any steps to implement its commitments regarding wholesaling services and commission agents' services provided by foreign-invested enterprises with respect to goods that they manufacture in China. Joint ventures have had the right to supply wholesaling (and retailing) services for the goods they manufacture in China since MOFTEC's issuance of the *Regulations for the Implementation of the Law on Chinese-Foreign Equity Joint Ventures* in December 1987. Similarly, wholly foreign-owned enterprises have this same right under the *Detailed Rules for the Implementation of the Law on Wholly Foreign-Owned Enterprises*, issued by MOFTEC in April 2001.

Meanwhile, China fell behind in implementing its commitments regarding wholesaling services and commission agents' services insofar as they relate to foreign-invested enterprises seeking to distribute goods made by other enterprises in China or imported goods. China was required to begin phasing in these commitments for joint ventures with minority foreign ownership on December 11, 2002. The phase-in was scheduled to extend to joint ventures with majority foreign ownership by December 11, 2003. Through the end of 2003 and well into 2004, however, China continued to limit wholesaling services and commission agents' services largely to joint ventures with minority foreign ownership, and it subjected these enterprises to a number of stringent qualification requirements and other restrictions.

The principal governing measure, issued in June 1999 by MOFTEC and the State Economic and Trade Commission (known as the SETC, it was subsequently merged into MOFCOM during the mid-2003 government restructuring), was the *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*. Under this measure, China permitted joint ventures with minority foreign ownership to apply for authority to engage in wholesaling services for domestic merchandise and merchandise imported for its own account in certain pilot areas (provincial capitals, certain municipalities and special economic zones), subject to certain product exceptions and stringent requirements. The foreign investor was required to have a minimum average annual merchandise wholesale volume of $2.5 billion during the preceding three years, along with minimum assets of $300 million during the preceding year. It was also required to be relatively strong economically, have advanced commercial experience and have an extensive international sales network. The Chinese investor was required to have minimum assets of RMB 50 million ($6.03 million) during the preceding year, or RMB 30 million ($3.62 million) if located in central or western China. In addition, if the Chinese investor was engaged in the wholesaling or retailing business, it was required to have minimum average annual sales volume of RMB 300 million

($36.2 million) during the preceding three years, or RMB 200 million ($24.1 million) if located in central or western China. If the Chinese investor was a trading enterprise, it was required to have minimum average annual volume of imports and exports for its own account of $50 million during the preceding three years, with exports accounting for at least $30 million. The Chinese investor was also required to be relatively strong economically and have relatively strong business capabilities, and it had to submit a feasibility study. The joint venture, meanwhile, was required to have minimum registered capital of RMB 80 million ($9.64 million), or RMB 60 million ($7.23 million) in central or western China. The joint venture was also required to comply with the commercial development plans of the city in which it is located.

One other measure, the January 2003 *Provisional Rules for the Establishment of Chinese-Foreign Equity Joint Venture Foreign Trade Companies* (discussed above in the Trading Rights section), extended the right to engage in wholesaling services to certain foreign-invested trading enterprises. Specifically, minority foreign-owned and (beginning December 11, 2003) majority foreign-owned joint ventures that qualify for trading rights under this measure's stringent requirements regarding trade volumes, registered capital and prior experience were permitted to engage in wholesaling services for the goods that they import.

In 2003, the United States pressed its concerns with China's then-existing wholesale regulations at the Trade Dialogue meetings held in Beijing in February and November as well as in several other bilateral meetings during the course of the year. The United States urged China to take immediate steps to bring its regulations into compliance with its phase-in commitments. The United States raised these same concerns during the transitional review held by the WTO's Council for Trade in Services in December 2003. The United States subsequently made distribution services – including wholesale services – one of its priority issues during the run-up to the April 2004 JCCT meeting, as it urged China to circulate and allow ample time for public comment on draft regulations implementing China's commitment to full liberalization in the important area of wholesale services, scheduled to be phased in on December 11, 2004.

In April 2004, following wide circulation of a draft, MOFCOM issued the *Measures on the Management of Foreign Investment in the Commercial Sector*, which supersede the June 1999 *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*. These regulations belatedly lift market access and national treatment restrictions on joint ventures engaging in wholesale services effective June 1, 2004. They also extend this liberalization to wholly foreign-owned enterprises and remove product exceptions for books, newspapers, magazines, pharmaceutical products, pesticides and mulching films (but not for chemical fertilizers, processed oil, crude oil, salt and tobacco) as of the scheduled phase-in date of December 11, 2004. The regulations require enterprises to obtain central or provincial-level MOFCOM approval before providing these services. In addition, they set relatively low qualifying requirements, as enterprises must only satisfy, for example, the relatively modest capital requirements of the *Company Law* rather than the high capital requirements found in many other services sectors.

While these regulations are welcome, MOFCOM has not yet issued any guidance regarding how its approval system will operate. The United States has urged China bilaterally and during the transitional review before the Council for Trade in Services in November 2004, with support from the European Communities (EC) and Japan, to ensure that appropriate guidance or implementing rules are issued without further delay. The United States will continue to press China on this matter until it is resolved.

Retailing Services

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

As in the wholesale area, China did not have to take any steps to implement its commitment to permit foreign-invested enterprises to supply retailing services for their own goods manufactured in China, which became effective upon China's accession. Joint ventures have had the right to supply retailing services for the goods they manufacture in China since MOFTEC's issuance of the *Regulations for the Implementation of the Law on Chinese-Foreign Equity Joint Ventures* in December 1987. Similarly, wholly foreign-owned enterprises have this same right under the *Detailed Rules for the Implementation of the Law on Wholly Foreign-Owned Enterprises*, issued by MOFTEC in April 2001.

Meanwhile, China fell behind in implementing its retailing services commitments insofar as they relate to joint ventures that do not manufacture their own goods in China. China was required

to begin phasing in these commitments for joint ventures with minority foreign ownership upon its accession, subject to geographic restrictions, quantitative restrictions and exceptions for a handful of listed goods. The phase-in was scheduled to extend to joint ventures with majority foreign ownership by December 11, 2003. Through the end of 2003 and into 2004, however, China continued to place severe restrictions on the supply of these services. Although China authorized retailing services to be supplied through joint ventures with minority foreign ownership and, in certain circumstances, joint ventures with majority foreign ownership, it maintained requirements that were burdensome and trade-restrictive. For example, onerous threshold requirements (relating to minimum wholesale volume, minimum imports and exports, minimum assets, minimum registered capital and prior experience) significantly reduced the number of enterprises that could qualify for the right to supply retailing services.

The principal governing measure was the June 1999 *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*, discussed above under Wholesaling Services and Commission Agents' Services. This measure permitted joint ventures to apply for authority to engage in retailing services, including sales on an agency basis and sales on a commission basis, along with relevant ancillary services, in the same pilot areas, subject to certain product exceptions and stringent requirements. The extent of foreign ownership permitted in these joint ventures depended on the nature of the retailing operations, while the requirements for the foreign investor, the Chinese investor and the joint venture were very similar to those that apply in the wholesale context. The foreign investor was required to have a minimum average annual merchandise sales volume of $2 billion during the preceding three years, along with minimum assets of $200 million during the preceding year. It was also required to be relatively strong economically, have advanced commercial experience and have an extensive international sales network. The requirements for the Chinese investor are identical to the ones applicable in the wholesale area. The joint venture, meanwhile, was required to have minimum registered capital of RMB 50 million ($6.03 million), or RMB 30 million ($3.62 million) in central or western China. As in the wholesaling services context, the joint venture also had to comply with the commercial development plans of the city in which it is located. Meanwhile, majority foreign ownership of up to 65 percent was permitted for joint ventures that establish not more than three branch stores or that operate convenience stores, specialty stores or exclusive stores as a chain. For joint ventures that operate more than three chain stores, the foreign investor was only entitled to minority ownership, except that foreign majority ownership could be permitted if the foreign investor had purchased large amounts of goods from China, the joint venture's business situation was relatively good, and the joint venture was able to use the foreign investor's international marketing network to expand the export of products from China. Finally, under this measure, a retail joint venture could not engage in the importing and exporting business, although it could import and export merchandise dealt in by itself.

In 2003, the United States raised its concerns with China's then-existing retail regulations at the Trade Dialogue meetings held in Beijing in February and November as well as in several other bilateral meetings during the course of the year, urging China to take immediate steps to bring its regulations into compliance with its commitments. The United States raised these same

concerns during the transitional review held by the Council for Trade in Services in December 2003 and also urged China to allow ample time for public comment on draft regulations implementing the important retail commitments scheduled to be phased in on December 11, 2004. The United States subsequently made distribution services – including retail services – one of its priority issues during the run-up to the April 2004 JCCT meeting, as it urged China to circulate and allow ample time for public comment on draft regulations implementing China's commitment to full liberalization.

In April 2004, following wide circulation of a draft, MOFCOM issued the *Measures on the Management of Foreign Investment in the Commercial Sector*, which supersede the June 1999 *Procedures for Pilot Projects for Commercial Enterprises with Foreign Investment*. These regulations belatedly lift market access and national treatment restrictions on joint ventures engaging in retail services effective June 1, 2004, except for allowed geographic and quantitative restrictions and product exceptions for pharmaceuticals, pesticides, mulching films and processed oil. The regulations also extend this liberalization to wholly foreign-owned enterprises and remove all remaining geographic and quantitative restrictions as of the scheduled phase-in date of December 11, 2004. The regulations require enterprises to obtain central or provincial-level MOFCOM approval before providing these services. In addition, they set relatively low qualifying requirements, as enterprises must only satisfy, for example, the relatively modest capital requirements of the *Company Law* rather than the high capital requirements found in many other services sectors.

While these regulations are welcome, as in the wholesale area, MOFCOM has not yet issued any guidance regarding how its approval system will operate. The United States has urged China bilaterally and during the transitional review before the Council for Trade in Services in November 2004, with support from the EC and Japan, to ensure that appropriate guidance or implementing rules are issued without further delay. The United States will continue to press China on this matter until it is resolved.

<u>Sales away from a fixed location</u>

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

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

Throughout 2004, MOFCOM has been drafting three measures to implement China's direct selling commitment, the *Measures for the Administration of Direct Marketing*, the *Measures for the*

*Administration of Sales Personnel Training* and the *Regulations on the Prevention of Anti-Pyramid Sales Scams*. Despite U.S. requests and the December 11 deadline for China to implement its direct selling commitment, MOFCOM has not made drafts of these measures available for public comment. To date, it has only discussed them in a November 2004 meeting with selected enterprises.

Based on the November 2004 meeting and subsequent bilateral engagement by the United States, it appears that 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 seem designed to make direct selling commercially unviable. The United States has urged MOFCOM to reconsider these provisions. Through the end of 2004 and into 2005, as necessary, the United States will work closely with U.S. companies in an effort to ensure that China develops and implements direct selling measures that facilitate legitimate commerce and are WTO-consistent.

## Import Regulation

### *Tariffs*

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

China implemented the tariff reductions that it was required to make on schedule on January 1, 2004. These tariff changes further increased market access for U.S. exporters in a range of industries, as China continued the process of reducing tariffs on goods of greatest importance to U.S. industry from a base average of 25 percent (in 1997) to 7 percent over a period of five years, running from January 1, 2002, while it made similar reductions throughout the agricultural sector (see the Agriculture section below). The reductions made on January 1, 2004, involved a range of sectors, including machinery, construction equipment, chemicals, and medical and scientific equipment, and contributed to another significant increase in U.S. exports, which rose approximately 35 percent from January through September 2004, when compared to the same time period in 2003.

In one of its more significant tariff initiatives, China continued its participation in the Information Technology Agreement (ITA), which requires the elimination of tariffs on computers, semiconductors and other information technology products. China began reducing and eliminating these tariffs in 2002 and continued to do so in 2003 and 2004, on schedule with its commitment to achieve the elimination of all ITA tariffs by January 1, 2005. U.S. exports of

ITA goods continued to perform well, as they increased by 45 percent from January through September 2004 and were projected to exceed $6 billion by the end of the year.

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 last year's healthy total of $3.9 billion.

A number of other industrial products benefitting 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, meanwhile, increased by 34 percent from January through September 2004, with a projected year-end total of $2.1 billion.

***Customs and Trade Administration***

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

Customs Valuation

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

On January 1, 2002, shortly after acceding to the WTO, China's General Administration of Customs (Customs Administration) issued the *Measures for Examining and Determining Customs Valuation of Imported Goods*. These regulations addressed the inconsistencies that had existed

between China's customs valuation methodologies and the Agreement on Customs Valuation. Nevertheless, China has not uniformly implemented these regulations. U.S. exporters continue to report that they are still encountering valuation problems at many ports. For example, even though the 2002 regulations provide that imported goods normally should be valued on the basis of their transaction price, meaning the price the importer actually paid, many Chinese customs officials are still improperly using "reference pricing," which usually results in a higher dutiable value. In addition, some of China's customs officials are reportedly not applying the provision in the 2002 regulations on conditions of sale as it relates to software. Following their pre-WTO accession practice, these officials are still automatically adding royalties and license fees to the dutiable value (for example, when an imported personal computer includes pre-installed software), even though China's new regulations direct them to add those fees only if they are paid to the exporter as a condition of the particular sale in question.

The United States first presented its concerns about the continuing customs valuation problems being encountered by foreign companies during a meeting of the WTO Committee on Customs Valuation in May 2003. At this meeting, China indicated that it was continuing to work to establish more uniformity in its adherence to WTO customs valuation rules. The United States also sought to address these issues in part by conducting technical assistance programs for Chinese government officials on WTO compliance in the customs area.

The Customs Administration subsequently issued the *Rules on the Determination of Customs Value of Royalties and License Fees Related to Imported Goods*, effective July 1, 2003. These rules were intended to clarify provisions of the January 2002 regulations that address the valuation of royalties and license fees, including with regard to the condition-of-sale requirement.

Near the end of 2003, another concern became more immediate. By December 11, 2003, China had committed to cease valuing digital products based on the imputed value of the content, which includes, for example, the data recorded on a floppy disk or CD-ROM. China committed to instead implement the Decision on Valuation of Carrier Media Bearing Software for Data Processing Equipment. 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. As the implementation deadline approached, the United States and other WTO members were concerned that China had not yet issued any draft or final regulations to implement the decision and, during the October 2003 transitional review before the Committee on Customs Valuation, urged China to act quickly. China indicated that it was in the process of drafting regulations and that it would implement this commitment in a timely manner. Shortly thereafter, in December 2003, the Customs Administration issued the final regulations, without having previously circulated a draft for public comment. U.S. exporters have since reported that China's implementation of these regulations in 2004 has been uneven, as the treatment of particular digital 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 high-value electronic media that are intended to be used after

importation to produce multiple copies of products such as DVDs for wide distribution and sale, the Customs Administration has been assessing duties 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. The United States will continue to engage China on this issue in 2005.

During meetings of the WTO Committee on Customs Valuation in 2004, the United States continued to raise its concerns about the continuing customs valuation problems being encountered by foreign companies, particularly with regard to the practice of using "reference pricing" and the valuation of royalties and license fees. By the end of the year, although some improvement appears to have taken place with regard to the valuation of royalties and license fees following the issuance of the *Rules on the Determination of Customs Value of Royalties and License Fees Related to Imported Goods*, these rules have not led to uniform, WTO-consistent implementation by China's customs officials in this area. Meanwhile, China has also made efforts to eliminate the practice of using "reference pricing." Nevertheless, this practice continues to be found at many ports.

Rules of Origin

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

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

In September 2004, the State Council finally issued the more important regulations intended to bring China's rules of origin into conformity with WTO rules for import and export purposes. Even though these regulations were in the process of being drafted for some time, China did not circulate a draft for public comment. At the October 2004 transitional review before the WTO Committee on Customs Valuation, the United States urged China to notify the regulations so that WTO members could review them and raise concerns or seek any needed clarifications from China. The regulations are scheduled to take effect on January 1, 2005, although necessary

implementing rules are still being drafted. The United States will carefully review both the regulations and the implementing rules as they become available.

Import Licensing

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

Shortly after China acceded to the WTO, MOFTEC issued regulations revising China's automatic import licensing regime, and it later supplemented these regulations with implementing rules. MOFTEC also issued regulations revising China's non-automatic licensing regime.

Since their issuance, the United States has raised various concerns with MOFCOM regarding the regulations on automatic and non-automatic licensing in an effort to promote clarity and to ensure that the licensing procedures do not have trade-distorting or restrictive effects. Together with other WTO members, including the EC and Japan, the United States also presented detailed comments on various aspects of these regulations at meetings of the WTO's Import Licensing Committee, including the transitional reviews, in 2002, 2003 and 2004.

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

***Non-tariff Measures***

In its accession agreement, China agreed that it would eliminate numerous trade-distortive non-tariff measures (NTMs), which included import quotas, licenses and tendering requirements covering hundreds of products. Most of these NTMs, including, for example, the NTMs covering chemicals, agricultural equipment, medical and scientific equipment and civil aircraft, had to be eliminated by the time that China acceded to the WTO. China committed to phase out other NTMs, listed in an annex to the accession agreement, over a transition period ending on January 1, 2005. With regard to the import quotas that were listed in the annex, which covered industrial goods such as autos and auto parts, crude oil, refined oil, and tires, China made a further commitment. It agreed to detailed procedures for allocating these quotas during the phase-out period. In a side letter, China also committed to make its quota system operational in time for applications to be accepted and quota allocations to take place by December 31, 2001.

From the outset, as has been previously reported, China's quota system was beset with problems. The State Council was late in issuing necessary regulations, and the authorities charged with implementing this system – MOFTEC for some products and SETC for others – were late in allocating quotas. Because of a lack of transparency, it was also difficult to assess whether the quotas were allocated in accordance with the agreed rules.

Some of the more difficult problems were encountered with the auto quota system, resulting at times in significant disruption of wholesale and retail operations for imported autos. The United States repeatedly raised its serious concerns with China's continuing implementation problems, both bilaterally and at the WTO. Then, in November 2003, China announced that certain U.S. auto companies would be authorized to import sizeable quantities of U.S.-produced autos in 2004 without having to use Chinese enterprises holding quotas. This development effectively ended the auto quota system for these companies as of the end of 2003, one year ahead of schedule.

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.

China eliminated the last of the other remaining NTMs on January 1, 2004, in accordance with the schedule set forth in its WTO accession agreement. These NTMs, which had taken the form of licensing and tendering requirements, had applied to a few types of industrial products, such as machine tools and aerials.

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

China agreed to implement a system of TRQs designed to provide significant market access for three industrial products, including fertilizer, a major U.S. export. Under this type of TRQ system, a set quantity of imports is allowed at a low tariff rate, while imports above that level are subject to a higher tariff rate. In addition, the quantity of imports allowed at the low tariff rate increases annually by an agreed amount.

China's accession agreement specifies detailed rules, requiring China to operate its fertilizer TRQ system in a transparent manner and dictating precisely how and when China is obligated to accept quota applications, allocate quotas and reallocate unused quotas. In a side letter, China also agreed to issue necessary regulations in draft form by mid-October 2001 and in final form by the date of its accession and that its TRQ system would be operational in time for applications to be accepted and quota allocations to take place by December 31, 2001.

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

In 2003, as the United States continued to engage China, SETC issued the quota allocations on time and apparently in the correct amount, representing a substantial improvement over 2002. However, U.S. companies continued to complain about administrative guidance discouraging TRQ holders from freely utilizing their quotas. According to reports from these companies, administrative guidance may have been used to limit imports of the principal U.S. fertilizer product, diammonium phosphate (DAP), to less than 60 percent of the quota allocations actually issued by SETC. From January through September 2003, U.S. fertilizer exports to China were down by 47 percent, totaling $274 million as compared to $520 million during the same period in 2002. In September 2003, however, a group of U.S. companies entered into a contract with a state trading enterprise to sell approximately $735 million of DAP in China between September 2003 and December 2005.

While the September 2003 DAP contract was encouraging, the systemic problems have not gone away, and U.S. fertilizer exports to China from January through September 2004 were down nearly 18 percent, totaling $225 million. Even after SETC was merged into MOFCOM as part of the mid-2003 government restructuring, it is still operating with insufficient transparency, and administrative guidance may still be affecting how allocated quota is used. The United States will

continue to monitor developments closely in 2005 and work to ensure that China fully complies with its commitments and administers its TRQ system in a transparent and fair manner.

***Other Import Regulation***

Antidumping

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

As reported in prior years, China made substantial progress in conforming the legal framework of its antidumping regime to the provisions and requirements of the WTO Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (AD Agreement), a trend that China continued over the last year. China has also emerged as a significant user of antidumping measures, with a total of 58 AD measures covering 17 countries currently in place and 35 new AD investigations in progress. According to U.S. AD experts, the greatest shortcomings to date in China's AD practice relate to transparency and fair procedures. The United States has been pressing China to clarify and address these concerns both bilaterally and multilaterally.

Shortly before China's accession to the WTO, the State Council issued new AD regulations, which became effective on January 1, 2002. These regulations replaced those that had governed China's AD regime since its beginning in 1997. In early 2002, MOFTEC, which at that time was charged with making determinations of dumping under the new regulations, issued several sets of rules covering initiation of investigations, questionnaires, sampling, verifications, information disclosure, access to non-confidential information, price undertakings, hearings, interim reviews, refunds and new shipper reviews. SETC, which at that time was charged with making determinations of injury, issued rules covering industry injury investigations and public hearings in January 2003.

In March 2003, a general reorganization of the State Council ministries and commissions consolidated the dumping functions of MOFTEC and the SETC into the newly formed MOFCOM. According to China's statements before the WTO's AD Committee, MOFCOM's Bureau of Fair Trade for Imports and Exports (BOFT) is now charged with making dumping determinations and MOFCOM's Bureau of Industry Injury Investigation (BIII) is now charged with making injury determinations. It appears that the State Council Tariff Commission continues to make the final decision on imposing, revoking or retaining AD duties, based on recommendations provided by the two MOFCOM bureaus, although its authority vis-à-vis

MOFCOM is not clearly defined in the new regulations or in subsequently issued revisions to various implementing rules.

A revised version of China's governing statute, the *Foreign Trade Law*, which included expanded trade remedy language, came into force on July 1, 2004. Although China had never notified the original version of the law to the WTO, it did recently notify the revised law, and U.S. AD experts are currently analyzing it for compliance with WTO obligations.

Of more immediate concern are reports by respondents in Chinese AD investigations, both from the United States and in some instances other countries, who continue to complain about the lack of detailed information made available to parties and the lack of disclosure of the facts that form the basis for decisions made by the administering authorities. While documents regarding BOFT's dumping investigations are reasonably available on demand, BIII has a spotty record of making available to respondents materials generated and submitted during the course of its injury investigations. Compounding this problem is the highly limited disclosure to interested parties by China's AD authorities of the essential facts underlying the decisions and calculations in both dumping and injury investigations. This dearth of disclosure impairs the ability of U.S. companies to mount an effective defense in Chinese AD investigations. For example, some recent reports criticize China's AD authorities for not providing appropriate opportunities for business to comment on and provide input into the government's deliberative process, the lack of domestic producer information or untimely access to such information, and the opaque nature of decision making in injury investigations, including demonstrating the causal link between injury and dumping.

At the WTO, in addition to addressing issues about China's practice in regular AD Committee meetings, the United States continues to vigorously make use of the China's annual transitional review to clarify issues and voice concerns regarding China's AD practices. During the most recent transitional review before the AD Committee, held in October 2004, the United States and other WTO members, including the EC and Japan, again raised concerns with China regarding transparency and fair procedures. The United States will continue to seek necessary clarifications in 2005.

Bilaterally, the United States has pursued capacity building efforts and regular dialogues with China. In December 2003, the U.S. Department of Commerce conducted an extensive trade remedy capacity building program in four cities in China. In April 2004, the United States and China agreed to establish the Trade Remedies Working Group at the JCCT meeting. This mechanism will allow U.S. AD experts to regularly engage Chinese administrators and decision-makers regarding areas of concern. U.S. AD experts also continue to have frequent formal and informal information exchanges with China's AD authorities, which helps to promote greater transparency and accountability in China's antidumping regime.

In addition, the United States is working closely with U.S. companies affected by Chinese AD investigations in an effort to help them better understand the Chinese system. The United States

also advocates on their behalf in connection with ongoing AD investigations, with the goal of obtaining fair and objective treatment for them, consistent with the WTO AD Agreement.

With China now having completed several AD investigations undertaken since its accession to the WTO, the opportunity for parties to seek judicial review has become more important. In August 2002, the Supreme People's Court issued *Rules Regarding Supreme People's Court Hearings on Judicial Review of International Trade Disputes*, which provide guidance concerning judicial review of administrative agency decisions affecting international trade, including those in the AD area. In September of the same year, the Supreme People's Court issued *Provisions of the Supreme People's Court on Certain Issues Concerning the Applicability of Laws in the Hearing and Handling of Antidumping Administrative Cases*. None of these rules has been formally submitted to the WTO, so there has been no opportunity for effective multilateral review of China's antidumping judicial review procedures. To the United States' knowledge, China's antidumping judicial review rules have never been tested. While many of China's AD investigations since joining the WTO have reached a final determination, it appears that no parties in those proceedings have sought judicial review.

The ongoing efforts of the United States and other WTO members urging improvements in China's AD regime appear to be having a positive effect on MOFCOM's transparency. MOFCOM recently issued new rules concerning the placement of documents in its public reading room, and it has begun to make some documents from the injury phase of AD investigations available. The United States will continue to pursue these and other issues in 2005, both at the WTO and bilaterally.

The United States will also continue to advocate on behalf of U.S. companies in connection with ongoing Chinese AD investigations in 2005.

Countervailing Duties

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

Shortly before China's accession, the State Council issued new CVD regulations, which came into force on January 1, 2002. Later, MOFTEC, which at that time was charged with making determinations of subsidization under China's CVD regime, issued several sets of ministerial rules on initiation of investigations, questionnaires, verifications and hearings. The SETC, which at that time was charged with making determinations of injury in China's CVD proceedings, issued implementing rules covering industry injury investigations and public hearings in January 2003.

In March 2003, a general reorganization of the State Council ministries and commissions consolidated the subsidization and injury investigation functions of MOFTEC and SETC into MOFCOM. The Supreme People's Court, meanwhile, issued new rules regarding judicial review in September 2002.

As in the AD area, China continues in its efforts to conform its CVD regulations and procedural rules to the provisions and requirements of the Subsidies Agreement and the commitments in its WTO accession agreement. China's regulations and procedural rules generally track those found in the Subsidies Agreement, although there are certain areas where key provisions are omitted or are vaguely worded. During the transitional reviews conducted in the WTO Subsidies Committee in 2003 and 2004, the United States and other WTO members sought to clarify issues concerning China's legislative and regulatory framework, including the roles and functions of the various administering authorities in a CVD proceeding, the definition of "subsidy" and "specificity" under China's CVD regulations, how China will determine injury, and China's provisions for ensuring respect for the confidentiality of submissions while providing transparency. The United States will continue to seek needed clarifications through the Subsidies Committee and bilateral contacts in 2005, including the Trade Remedies Working Group established at the April 2004 JCCT meeting.

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

Safeguards

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

Shortly before China's WTO accession, the State Council issued the *Regulations on Safeguards*, which became effective on January 1, 2002. Under these regulations, the former MOFTEC was responsible for determining whether the volume of imports of a given product has increased and (together with the former SETC) whether there is a causal link between any such imports and injury to the domestic industry. MOFTEC issued two sets of provisional procedural rules, one covering initiations and the other hearings. SETC, the agency that was charged with determining injury to the domestic industry issued the *Rules on Investigations and Determinations of Industry Injury for Safeguards* and the *Rules on Public Hearings with regard to Investigations of Injury to Industry* in early 2003. In 2003, a general reorganization of the State Council ministries and commissions consolidated the safeguard functions of MOFTEC and SETC into MOFCOM and, in 2004, the State Council issued revised *Regulations on Safeguards* and MOFCOM issued revised implementing rules to reflect this change.

As with the AD and CVD areas, it appears that China has made an effort to establish a WTO-consistent safeguard regime, as the provisions of China's regulations and procedural rules generally track those of the Safeguards Agreement. However, certain omissions and ambiguities remain, and some provisions do not find a counterpart in the Safeguards Agreement and may be inconsistent with it. In the October 2004 transitional review before the WTO's Committee on Safeguards, the United States noted several areas of potential concern, including transparency, determination of developing country status, treatment of non-WTO members, protection of confidential data, access to non-confidential information, refunding of safeguard duties collected pursuant to provisional measures when definitive measures are not imposed, and the conditions governing the extension of a safeguard measure. The United States will continue to pursue these issues, both within the Committee on Safeguards and in bilateral contacts.

In May 2002, MOFTEC initiated China's first and only safeguard proceeding. The investigation addressed imports of certain steel products from various countries, including the United States. China imposed provisional measures in the form of tariff-rate quotas on nine categories of products the day after initiation, and six months later it rendered a final determination maintaining these measures in place. U.S. companies export little of the subject merchandise to China, although those that did complained that China's process for allocating quotas under the safeguard measures was unclear, making it difficult for them to determine the quota available and obtain a fair share. MOFCOM terminated the safeguard measures in December 2003.

**Export Regulation**

China's WTO accession agreement reinforces China's obligation to only maintain export restrictions allowed under WTO rules. Article XI of the General Agreement on Tariffs and Trade 1994 (GATT 1994) generally prohibits WTO members from maintaining export restrictions (other than duties, taxes or other charges), although certain limited exceptions are allowed.

China also agreed to eliminate all taxes and charges on exports, except as included in Annex 6 to the Protocol of Accession or applied in conformity with Article VIII of GATT 1994. Article VIII of GATT 1994 only permits fees and charges limited to the approximate cost of services rendered and makes clear that any such fees and charges shall not represent an indirect protection to domestic products or a taxation of exports for fiscal purposes.

Since its accession to the WTO, China has continued to impose restrictions on exports of a few raw materials and intermediate products. In an attempt to justify these restrictions, MOFCOM has cited Article XX(g) of GATT 1994, which permits a WTO member to impose measures relating to the conservation of exhaustible natural resources, provided that such measures are made effective in conjunction with restrictions on domestic production or consumption, and provided they are not applied in a manner that would constitute a means of arbitrary or

unjustifiable discrimination between countries where the same conditions prevail or a disguised restriction on international trade.

In 2004, China's export restrictions on blast furnace coke, a key steel input, began to have a significant, adverse effect on U.S. integrated steel producers and their customers. China is the world's largest producer of coke, with total production of 177.7 million MT in 2003, as well as the world's most significant exporter of coke, supplying more than one-half of the world's traded coke. In 2004, China initially imposed an export quota of 8.3 million MT, down from the 2003 level of 14.3 million MT. In the first six months of 2004, China's export quota, combined with the illegal sale of export quota certificates, caused the export price for Chinese coke to rise to the vicinity of $500 per MT, more than three times the price in 2003. This price rise triggered a similar rise in world coke prices, while Chinese domestic prices ranged between $150 and $200 per MT.

The United States began to raise its concerns with China's coke export restrictions during high-level meetings in Washington in April 2004. The United States urged China to put the practice of using export restrictions behind it, not just for coke but also for other products.

The EC also became active in addressing this issue, as European steel producers normally source one-third of their coke needs from China. In May 2004, the EC reportedly used the threat of WTO dispute settlement to obtain China's agreement to guarantee European purchasers 4.5 million MT of Chinese coke in 2004, the same level that they had purchased in 2003.

As the U.S. industry became more concerned about decreased access to Chinese coke, along with soaring prices, the United States continued to engage China on this issue, both through high-level contacts and in a series of other meetings in May, June and July 2004 in Beijing. The United States sought to ensure that U.S. purchasers would have sufficient access to Chinese coke in 2004, pressed China to eliminate immediately the high export license fees resulting from the sale of export licenses, and urged China to establish a timetable for ending its export quota system. The EC and other WTO members also continued to raise their concerns with China.

In late July 2004, China raised the 2004 quota allotment to 12.3 million MT, and it indicated that it would eventually be raising the quota to the 2003 level of 14.3 MT. It did not, however, provide for country-specific quota allocations, instead continuing to leave it to individual purchasers to secure their own coke needs. Shortly thereafter, MOFCOM also issued an urgent notice reiterating that the sale of export licenses was illegal, calling for investigations into this practice by provincial MOFCOM authorities, and demanding reports by August 15.

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, nearly reaching $200 per MT. U.S. industry was also able to obtain a substantially larger quantity of Chinese coke in 2004 than it had in 2003.

In September and November 2004, the United States continued to press China for complete elimination of the annual export quota on coke. Along with other WTO members, including the EC and Japan, the United States raised its concerns at the WTO during the transitional reviews before the Committee on Market Access and the Council for Trade in Goods as well as during side meetings. The United States also reiterated its concerns in bilateral meetings in Beijing in November 2004. The United States will continue to pursue this issue vigorously in 2005.

Fluorspar is another example of a raw material subject to export restrictions. China imposes quotas and license fees on fluorspar exports, apparently with the objective of supporting China's domestic users of fluorspar, which face no comparable restrictions. Since shortly after China's WTO accession, the United States has raised its concerns about these restrictions bilaterally with China. The United States has also worked with other WTO members with an interest in this issue, including Japan, and it raised this issue during the transitional reviews of China's compliance efforts before the Council for Trade in Goods in 2002 and 2003 and both the Committee on Market Access and the Council for Trade in Goods in 2004. To date, however, China has refused to modify its practices in this area. The United States will continue to urge China to lift these restrictions in 2005.

## Internal Policies Affecting Trade

### *Non-discrimination*

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

The MFN rule (set forth in Article I of GATT 1994) attempts to put the goods of all of an importing WTO member's trading partners on equal terms with one another by requiring the same treatment to be applied to goods of any origin. It generally provides that if a WTO member grants another country's goods a benefit or advantage, it must immediately and unconditionally grant the same treatment to imported goods from all WTO members. This rule applies to customs duties and charges of any kind connected with importing and exporting. It also applies to internal taxes and charges, among other internal measures.

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

internal sale, purchase, transportation, distribution or use of goods, the importing WTO member may not treat imported goods less favorably than domestic goods.

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

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

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

However, China does not appear to have observed MFN and national treatment requirements in all areas. For example, U.S. pharmaceutical manufacturers continue to raise national treatment concerns in the areas of price controls on medicines and drug reimbursement. Actions taken by China in these areas often appear to be designed to benefit domestic pharmaceutical manufacturers at the expense of foreign pharmaceutical manufacturers. The United States has urged the Chinese regulatory authorities to work with U.S. companies when making changes in these areas and to adhere strictly to China's WTO obligations. The United States will continue to monitor these areas closely in 2005.

China's border trade policy continues to generate MFN and other concerns. China provides preferential import duty and VAT treatment to certain products, often from Russia, apparently even when those products are not confined to frontier traffic as envisioned by Article XXIV of GATT 1994. In June 2003, China began to address these concerns when it eliminated

preferential treatment for boric acid and 19 other products. However, several other products continue to benefit from preferential treatment.

Furthermore, several U.S. industries reported that China continued to apply the value-added tax in a manner that unfairly discriminates between imported and domestic goods, both through official measures and on an *ad hoc* basis, as discussed below in the Taxation section. It also appears that China has applied sanitary and phytosanitary measures in a discriminatory manner continually since it acceded to the WTO, as discussed below in the Agriculture section.

The United States continued to address the range of MFN and national treatment issues with China in 2004, both bilaterally and in WTO meetings, such as the transitional reviews before the Council for Trade in Goods. The United States will continue to pursue these issues in 2005.

Meanwhile, China did undertake a major restructuring of its trade and investment-related ministries in mid-2003, following significant changes in the leadership of China's Communist Party and the national government. One principal component of this restructuring was combining domestic and foreign trade-related functions into one agency (as SETC and parts of the State Development and Planning Commission, or SDPC, were folded into MOFTEC, which became known as the Ministry of Commerce, or MOFCOM), in part to foster better adherence to the WTO's national treatment principle. In addition, the successor to SDPC, the National Development and Reform Commission (NDRC), has become much more open to discussing the policy concerns of foreign businesses, which contrasts sharply with its prior reputation.

***Taxation***

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

<u>VAT Policies</u>

Certain aspects of China's VAT system continued to raise serious national treatment concerns in 2004, particularly with regard to the discriminatory rates being applied to imports versus domestically produced semiconductors and fertilizer.

China began to encourage the development of China's domestic integrated circuit (IC) industry through the announcement of discriminatory VAT policies beginning shortly before its WTO accession, although they did not become operational until 2004. Pursuant to a series of measures, China provided for the rebate of a substantial portion of the 17 percent VAT paid by domestic manufacturers on their locally produced ICs. A similar VAT rebate was available to imported ICs, but only if they had been designed in China. China charged the full 17 percent VAT on all other imported ICs.

The United States raised this issue with China in several bilateral meetings, including the Trade Dialogue held in Beijing in February 2003, and at the WTO during the transitional review before the Committee on Market Access in October 2003. In August 2003, in response to the concerns raised by the United States, China reportedly formed an inter-agency group, composed of representatives from the Ministry of Information Industry (MII), the State Taxation Administration, the Customs Administration and MOFCOM, to evaluate the WTO-compatibility of its tax treatment of ICs. However, during high-level meetings in Beijing in October 2003 and again during the November 2003 Trade Dialogue, China appeared to have hardened its conviction that its differential tax treatment of ICs was consistent with its WTO obligations.

During the run-up to the April 2004 JCCT meeting, it became clear that further talks would not convince China to eliminate its differential tax treatment of imported ICs. With U.S. exports of ICs to China totaling approximately $2 billion in 2003 and growing, and with China's policies encouraging the shifting of investment in IC manufacturing to China, the United States took appropriate action at the WTO. The United States initiated dispute settlement in March 2004 by requesting formal consultations with China. In the ensuing consultations, which took place in April 2004 in Geneva, with third party participation by Japan, the EC and Mexico, the United States laid out its claims under Article III of GATT 1994, which sets forth the WTO's national treatment principle. Shortly thereafter, China signaled its willingness to discuss a possible resolution of this matter. A series of bilateral meetings subsequently took place in Washington and Beijing, and in July 2004 a settlement was reached. China agreed to immediately cease adding Chinese IC manufacturers to the list of entities eligible for the VAT rebate and to issue the necessary regulations to eliminate the VAT rebate entirely by November 1, 2004, to be effective 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, to be effective no later than October 1, 2004.

China has also used VAT policies to benefit domestic fertilizer production. In July 2001, the Ministry of Finance (MOF) and the State Administration of Taxation issued a circular exempting all phosphate fertilizers except DAP from a 13 percent VAT. DAP, a product that the United States exports to China, competes with similar phosphate fertilizers produced in China, particularly monoammonium phosphate. The circular also allowed a partial VAT rebate for domestic producers of urea, a nitrogen fertilizer, through the end of 2002. The United States raised this issue bilaterally with China soon after it acceded to the WTO, and in many subsequent bilateral meetings, including the Trade Dialogue meetings held in February and November 2003, among other high-level meetings. The United States also raised this issue at the WTO, both in regular meetings of the Committee on Market Access and during the transitional reviews held in 2002, 2003 and 2004. So far, however, China has refused to make any changes, although it did allow the special tax treatment for domestic urea to expire at the end of 2002. The United States will continue to press its concerns regarding this issue in 2005.

Meanwhile, several U.S. industries have complained more generally about the unfair operation of China's VAT system. Often, Chinese producers are able to avoid payment of the VAT on their products, either as a result of poor collection procedures, special deals or even fraud, while the full VAT still must be paid on competing imports. In discussions with Chinese government officials on this issue, the United States has raised its serious concerns about the discriminatory treatment effectively accorded to foreign products. The United States has also emphasized the value to China of a properly functioning VAT system as a revenue source, and it has continued to explore possible technical assistance that might help to alleviate this problem.

Consumption Taxes

National treatment concerns also continue to surround China's consumption tax regulations, which first went into effect in 1993 and apply to a range of consumer products, including spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles. Under these regulations, China uses different tax bases to compute consumption taxes for domestic and imported products, with the apparent result that the effective consumption tax rate for imported products is substantially higher than for domestic products. Since China's accession, the United States has raised this issue with China, both bilaterally and during the transitional reviews conducted by the WTO Committee on Market Access in 2002, 2003 and 2004. However, China has so far not revised these regulations. The United States will continue to insist on the revision of these regulations in 2005.

***Subsidies***

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

China also agreed to various special rules which apply when other WTO members seek to enforce the disciplines of the Subsidies Agreement against Chinese subsidies (either in individual WTO members' CVD proceedings or in WTO enforcement proceedings). Under these rules, in certain circumstances, WTO members can identify and measure Chinese subsidies using alternative methods in order to account for the special characteristics of China's economy. For example, in certain circumstances, when determining whether preferential government benefits have been provided to a Chinese enterprise via, e.g., a loan, WTO members can use foreign or other

market-based criteria rather than Chinese benchmarks to ascertain the preferentiality of that loan and its terms. Special rules also govern the actionability of subsidies provided to state-owned enterprises.

After three years of WTO membership, China had still not fulfilled one key requirement of the Subsidies Agreement, which is to notify certain information about its subsidy programs to the WTO (on an annual basis). Timely and informative notifications are vital to satisfying the rights of other WTO members to know and understand the range and operation of a member's subsidy programs and to be assured that the member is not maintaining any prohibited subsidies. Although China submitted a subsidies notification in an annex to its accession agreement, that notification only contained information through 1998 or 1999, and China acknowledged that it was far from comprehensive.

The United States has raised China's failure to make a subsidies notification in every transitional review before the WTO's Subsidies Committee, including the one held in November 2004, during which the United States and other WTO members, including the EC, again urged China to submit a full and updated notification as soon as possible. In addition, in advance of the November meeting of the Subsidies Committee, the United States submitted a request under Article 25.8 of the Subsidies Agreement for China to provide detailed information regarding several programs and practices that appeared to constitute subsidies. The request identified programs and practices providing benefits to agricultural products, forest and paper products, textiles and various high technology products, among others, and included some programs and practices that appeared to constitute prohibited subsidies within the meaning of Article 3 of the Subsidies Agreement. At the November 2004 Subsidies Committee meeting, China made no commitment to make a subsidies notification or to provide the specific information requested by the United States. During the transitional review before the Council for Trade in Goods later in November 2004, however, China did commit to submit its long-overdue subsidies notification within the next year.

In 2005, the United States will maintain a focus on China's commitment to provide a subsidies notification, both at the WTO and through vigorous bilateral engagement. The United States will also continue to investigate and analyze Chinese subsidy programs and practices.

### *Price Controls*

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

In 2004, China continued to maintain price controls on several products and services covering both state-owned enterprises and private enterprises. These price controls may be in the form of either absolute mandated prices or specific pricing policy guidelines as directed by the government and include items such as pharmaceuticals, natural gas, transportation (including freight transportation), and tobacco and certain other agricultural products. Until this year, information on price controls was published in the Gazette of the People's Republic of China, which has been discontinued. Now, price control information, including the list of products and services subject to pricing administration, price-setting mechanisms and pricing policies, are published through the China Economic Herald and the NDRC's website.

During the transitional review before the Subsidies Committee in November 2004, as in prior years, the United States sought updated information from China on its use of price controls and future plans, with a particular focus on input pricing. The United States will continue to monitor China's progress in eliminating price controls in 2005.

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

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

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

In addition, in the Services Schedule accompanying its WTO accession agreement, China committed to permit foreign service suppliers that have been engaged in inspection services in their home countries for more than three years to establish minority foreign-owned joint venture

technical testing, analysis and freight inspection companies upon China's accession to the WTO, with majority foreign ownership no later than two years after accession and wholly foreign-owned subsidiaries four years after accession. China further agreed that qualifying joint venture and wholly foreign-owned enterprises would be eligible for accreditation in China and accorded national treatment.

Restructuring of Regulators

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

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

Transparency

In the area of transparency, AQSIQ's TBT inquiry point, established shortly after China acceded to the WTO, has continued to be helpful to U.S. companies as they try to navigate China's system of standards, technical regulations and conformity assessment procedures. In addition, China's designated notification authority, MOFCOM, has been notifying proposed technical regulations and conformity assessment procedures to WTO members, as required by the TBT Agreement. Almost all of these notified TBT measures have emanated from AQSIQ or SAC, however, and have not included measures from other agencies that appear to require notification. In late 2003, in part to address this problem, China reportedly formed a new inter-agency committee, with representatives from approximately 20 ministries and agencies and chaired by AQSIQ, to achieve better coordination on TBT (and sanitary and phytosanitary) matters. In

addition, in 2004, SAC circulated a series of draft reports studying how to inject more transparency into the standards-setting process in China. The United States, meanwhile, has been working to bring notification-related questions to the attention of the relevant Chinese government officials so that they can be addressed on a timely basis.

As the United States pointed out during the transitional review before the TBT Committee in November 2004, as in prior years, the comment periods established by China for the TBT measures actually notified were unacceptably brief in some cases. In other cases, some U.S. companies reported that even when sufficient time was provided, written comments submitted by U.S. and other foreign interested parties seemed to be wholly disregarded. In still other cases, insufficient time was provided for Chinese regulatory authorities to consider interested parties' comments before a regulation was adopted.

Standards and Technical Regulations

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. However, in a number of sectors, including, for example, autos, telecommunications equipment, wireless local area networks, radio frequency identification tag technology, audio video coding, whiskey and other distilled spirits, and fertilizer, concern has grown over the past few years as China is actively pursuing the development of unique requirements, despite the existence of well-established international standards. This course of action will create significant barriers to entry into its markets, as the cost of compliance will be high for foreign companies. At the same time, China will also be placing its own companies at a disadvantage in its export markets, where international standards prevail.

A particularly significant example of China's pursuit of unique requirements arose in May 2003, when China issued two mandatory standards for encryption over Wireless Local Area Networks (WLANs), applicable to domestic and imported equipment containing WLAN (also known as Wi-Fi) technologies. These standards, which were originally scheduled to go into effect in December 2003 and were never notified to the TBT Committee, incorporated the WLAN Authentication and Privacy Infrastructure (WAPI) encryption technique for secure communications. This component of the standards differed significantly from the internationally recognized standard that U.S. companies have adopted for global production, and China was set to enforce it by providing the necessary algorithms only to eleven Chinese companies. U.S. and other foreign manufacturers would have to work with and through these companies, some of which are their competitors, and provide them with technical product specifications, if their products were to continue to enter China's market.

Working closely with U.S. industry, the United States repeatedly raised its concerns with China throughout the remainder of 2003 regarding the WAPI issue. The United States focused on the WTO compatibility of China's implementation of the standards, including the denial of national

treatment to imported products, the use of standards that are more trade-restrictive than necessary to fulfill a legitimate objective, the use of mandatory standards that do not comply with accepted international standards, local content requirements for access to the Chinese market, and the lack of notification of these standards to the WTO.

In 2004, the United States continued to press China on the WAPI issue, making it one of the United States' priority issues during the run-up to the April 2004 JCCT meeting. The United States was particularly concerned about the precedent that could be established if China were allowed to enforce unique mandatory standards in the fast-developing information technology sector. During the JCCT meeting, the United States and China were able to resolve the WAPI issue. China announced that it 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.

The United States also elevated another standards issue to the JCCT level. The U.S. telecommunications industry was very concerned about increasing interference from Chinese regulators, both with regard to the selection of 3G telecommunications standards and in the negotiation of contracts between foreign telecommunications service providers and their Chinese counterparts. During the run-up to the April 2004 JCCT meeting, the United States continually urged China to take a market-based and technology neutral approach to the development of next generation wireless standards for computers and mobile telephones. Demonstrating progress in moving away from industrial policies in favor of market mechanisms, China announced that it would support technology neutrality with regard to the adoption of 3G telecommunications standards and that telecommunications service providers in China would be allowed to make their own choices about which standard to adopt, depending on their individual needs. China also announced that Chinese regulators would not be involved in negotiating royalty payment terms with relevant intellectual property rights holders. However, by the end of the year, it had become evident that there was still pressure from within the Chinese government to ensure a place for China's home-grown 3G telecommunications standard. The United States will therefore carefully monitor developments in this area in 2005.

Near the end of 2003, AQSIQ issued a notice announcing the creation of a new requirement that exporters of recycled scrap to China must register with AQSIQ. Although this notice established a deadline of July 1, 2004, it was not until May 2004 that AQSIQ issued a second notice establishing the procedures and substantive requirements that recycled scrap exporters must satisfy to register with AQSIQ. U.S. exporters, which account for nearly $2 billion of recycled scrap exports to China annually, were concerned because several of the procedures and substantive requirements established by AQSIQ lacked clarity. During ensuing discussions with U.S. government and private sector representatives, AQSIQ provided needed clarifications and subsequently showed some flexibility by agreeing to extend the deadline for filing an application to August 1, 2004. AQSIQ also indicated that exporters that filed incomplete applications

would have until September 30, 2004 to correct their applications. However, the United States was still concerned because it appeared that existing shippers, or new shippers, that missed the August 1, 2004 application deadline would be precluded by AQSIQ from applying for registration until some indefinite time in the future. While the United States recognized that AQSIQ may have a legitimate basis for insisting that the exporters complete the registration process and obtain a registration number before exporting to China, it did not agree that AQSIQ had a legitimate basis for effectively barring their registration by not allowing them to apply after a certain date. Following further bilateral engagement, AQSIQ announced in October 2004 that it would delay implementation of the new registration requirement from November 1, 2004 until January 1, 2005. To date, hundreds of U.S. exporters have become registered suppliers of recycled scrap. As 2004 was drawing to a close and successful registrations continued to be announced, the United States was carefully reviewing the results of the registration process. The United States will examine closely AQSIQ's implementation of the new registration requirement once it becomes fully operational in 2005.

As previously reported, in October 2003, in order to increase U.S.-China cooperation on issues relating to standards and technical regulations, the United States obtained AQSIQ's support in principle for the establishment of a new U.S. private sector standards office in Beijing. This new office, which received funding from the U.S. Department of Commerce in October 2004 to facilitate its opening and operation, will focus on strengthening ties with Chinese government regulatory authorities, Chinese industry associations and Chinese standards developers and, in particular, on ensuring that close communication exists between U.S. and Chinese standards developers.

The United States also continued to provide technical assistance to China on both standards and conformity assessment procedures. In 2004, this technical assistance focused on broad standards-development issues as well as specific standards in a number of industries, including information and telecommunications technology, steel, petroleum, water conservation, energy efficiency, hydrogen infrastructure, elevators, electrical safety, gas appliances and heating, ventilation and air conditioning.

<u>Conformity Assessment Procedures</u>

As previously reported, AQSIQ's regulations establishing a new Compulsory Product Certification System, issued in December 2001, took full effect on August 1, 2003, following a transition period that lasted for fifteen months. Under this system, there is now one safety mark, called the "China Compulsory Certification" or "CCC" mark, issued to both Chinese and foreign products. Under the old system, domestic products were only required to obtain the "Great Wall" mark, while imported products needed both the "Great Wall" mark and the "CCIB" mark. In 2004, U.S. companies continued to complain that the regulations lack clarity regarding the products that require a CCC mark. They also have reported that China is applying the CCC mark requirements inconsistently and that many domestic products required by AQSIQ's regulations to have the CCC mark are still being sold without the mark. In addition, despite the

changes made by the regulations, U.S. companies in some sectors continued to complain in 2004 about duplication in certification requirements, particularly for telecommunications products.

Meanwhile, to date, China has granted 68 Chinese enterprises accreditation to test and certify for purposes of the CCC mark. Despite China's commitment that qualifying minority foreign-owned (upon China's accession to the WTO) and majority foreign-owned (two years later) joint venture conformity assessment bodies would be eligible for accreditation and would be accorded national treatment, China so far has not granted accreditation to any foreign-invested enterprises.

In 2004, as in prior years, the United States raised its concerns in this area with China bilaterally and during meetings of the WTO's TBT Committee, including the transitional review held in November 2004, where it received support from the EC and Japan. The United States will continue to be in close contact with the relevant Chinese authorities in these areas in 2005.

### *Other Internal Policies*

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

While many provisions in China's WTO accession agreement indirectly discipline the activities of state-owned and state-invested enterprises, China also agreed to some specific disciplines. In particular, it agreed that laws, regulations and other measures relating to the purchase of goods or services for commercial sale by state-owned and state-invested enterprises, or relating to the production of goods or supply of services for commercial sale or for non-governmental purposes by state-owned and state-invested enterprises, would be subject to WTO rules. China also affirmatively agreed that state-owned and state-invested enterprises would have to make purchases and sales based solely on commercial considerations, such as price, quality, marketability and availability, and that the government would not influence the commercial decisions of state-owned and state-invested enterprises. Since China's accession to the WTO, U.S. officials have not heard complaints from U.S. companies regarding WTO compliance problems in this area, although a lack of available information continues to make it a difficult area to assess.

#### State Trading Enterprises

In its WTO accession agreement, China also agreed to disciplines on the importing and exporting activities of state trading enterprises. China committed to provide full information on the pricing mechanisms of state trading enterprises and to ensure that their import purchasing procedures are transparent and fully in compliance with WTO rules. China also agreed that state trading enterprises would limit the mark-up on goods that they import in order to avoid trade distortions. Since China's WTO accession, the United States and other WTO members have sought information from China on the pricing and purchasing practices of state trading enterprises, principally through the transitional reviews at the WTO. So far, however, China has only

provided general information, which does not allow a meaningful assessment of China's compliance efforts.

Government Procurement

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

At present, China is not a GPA member. It committed to become an observer to the GPA upon its WTO accession, and in February 2002 it became an observer to the WTO Committee on Government Procurement. China also committed, in its WTO accession agreement, to initiate negotiations for accession to the GPA "as soon as possible," but it has not yet done so. In late 2003, MOF established a working group to study the possibility of initiating negotiations for accession to the GPA. In response to U.S. questions during the transitional review before the Council for Trade in Goods in November 2004, China stated that the working group was still studying the issue.

In 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 June 2002, China adopted its *Government Procurement Law*, which became effective on January 1, 2003. This law attempts to follow the spirit of the GPA and incorporates provisions from the United Nations Model Law on Procurement of Goods. The law also directs central and sub-central government entities to give priority to "local" goods and services, with limited exceptions, as China is permitted to do, because it is not yet a GPA member. China envisions that this law will improve transparency, reduce corruption and lower government costs, and it 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.

China began the process of drafting regulations implementing the *Government Procurement Law* in 2002. MOF circulated a draft of the *Measures on the Administration of Bidding for Government-Procured Goods and Services* for public comment in December 2002. The United States submitted written comments, which focused on promoting transparency and clarifying the scope and coverage of the *Government Procurement Law*. The United States followed up on these comments during bilateral meetings with MOF officials. MOF issued the final version of the

regulations in August 2004. These regulations set out detailed procedures for the solicitation, submission and evaluation of bids for government procurement contracts relating to goods ands services and help to clarify the scope and coverage of the *Government Procurement Law*. At the same time, MOF also issued several sets of implementing rules, including measures relating to the announcement of government procurements and the handling of complaints by government procurement suppliers.

In 2005, the United States will continue to urge China to initiate negotiations for accession to the GPA. It will also monitor the treatment accorded to U.S. suppliers under the *Government Procurement Law* and urge China to apply its new regulations and implementing rules in a transparent, non-discriminatory manner.

Meanwhile, U.S. companies continued to express concern about the implementing rules on government software procurement being drafted by MOF. As initially drafted in 2003, when China's 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 – the largest purchasers of software in China – should purchase software developed in China to the extent possible. Later that year, the United States organized an industry roundtable to inform the relevant Chinese ministries of the views and concerns of interested U.S. trade associations. U.S. industry officials have pointed out that the creation of a domestic software industry cut off from global standards would lead to inefficiencies and would limit, rather than promote, the development of China's software industry. At the roundtable, Chinese government officials explained that they were considering a definition for "domestic products" that would include products of foreign companies with established roots in China.

In October 2004, MOF issued a notice seeking input from foreign enterprises regarding the software procurement rules being drafted. Although no actual draft of those rules was included, it appeared that MOF was taking a very restrictive approach in defining "domestic products." Working closely with U.S. industry, the United States submitted written comments to MOF in November 2004. Concerned that China could pursue a similar approach in other sectors, the United States strongly reiterated its concerns with China during ensuing bilateral meetings in Beijing and Geneva.

**Investment**

The Agreement on Trade-Related Investment Measures (TRIMS Agreement) prohibits investment measures that violate GATT Article III obligations to treat imports no less favorably than domestic products or the GATT Article XI obligation not to impose quantitative restrictions on imports. The TRIMS Agreement thus expressly requires elimination of measures such as those that require or provide benefits for the incorporation of local inputs ("local content requirements") in the manufacturing process, or measures that restrict a firm's imports to an amount related to its exports or related to the amount of foreign exchange a firm earns ("trade balancing requirements"). In its accession agreement, China also specifically agreed to eliminate

export performance, local content and foreign exchange balancing requirements from its laws, regulations and other measures, and not to enforce the terms of any contracts imposing these requirements. In addition, China agreed that it would no longer condition importation or investment approvals on these requirements or on requirements such as technology transfer and offsets.

Beginning before its accession to the WTO, 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. However, some of the revised laws and regulations 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 in 2004 still consider factors such as export performance and local content when deciding whether to approve an investment or to recommend approval of a loan from a Chinese policy bank, which is often essential to the success of an investment project. The United States and other WTO members, including the EC and Japan, raised concerns in this area during the transitional reviews conducted by the WTO's Committee on Trade-Related Investment Measures (TRIMS Committee) in 2002, 2003 and 2004. The United States will continue to follow this situation closely in 2005.

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

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

with its commitment to provide an opportunity for public comment on new or revised trade-related laws and regulations.

The United States continued to press China bilaterally on this issue in 2004. In May 2004, China issued the final version of its new automobile industrial policy. This policy had been revised to eliminate any requirement that separate distribution channels be used for domestic and imported autos, although it continued to include provisions discouraging the importation of auto parts and encouraging the use of domestic technology. It also included a number of provisions that were too vague to assess, such as in the area of complete knocked-down auto kits. The United States, the EC and Japan sought clarifications on these matters during the transitional reviews before the Committee on Market Access, the TRIMS Committee and the Council for Trade in Goods in September, October and November 2004. The United States will closely monitor how China implements its new automobile industrial policy in 2005.

In 2004, the State Council made no changes to the *Sectoral Guidelines Catalogue for Foreign Investment*. This catalogue, when last issued in March 2002, had reflected China's decision to adhere to its commitment to open up certain sectors to foreign investment, including travel agencies, human resources companies, cinemas, railway cargo and publications distribution (see the Services section below), while it had also signaled the opening-up of a number of other sectors not covered by China's accession agreement. One notable exception to this progress was the area of production and development of genetically modified plant seeds, which China changed to the "prohibited" category. During the transitional review before the TRIMS Committee in October 2004, China indicated that it had no immediate plans to revise the catalogue.

**Agriculture**

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

In the area of market access, WTO members committed to the establishment of a tariff-only regime, tariff reduction and the binding of all tariffs. As a result of its accession negotiations, China agreed to significant reductions in tariff rates on a wide range of agricultural products. China also agreed to eliminate quotas and implement a system of TRQs designed to provide significant market access for certain bulk commodities upon accession. This TRQ system is very similar to the one governing fertilizers (discussed above in the Import Regulation section). China's goods schedule sets forth detailed rules intended to limit the discretion of the agriculture TRQ administrator, the SDPC (known as the National Development and Reform Commission, or NDRC, since the March 2003 government restructuring) and to require SDPC to operate with transparency and according to precise procedures for accepting quota applications, allocating quotas and reallocating unused quotas.

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

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

Another important agricultural area is covered by the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement), under which China also became obligated. The SPS Agreement establishes rules and procedures regarding the formulation and application of sanitary and phytosanitary measures, i.e., measures taken to protect against risks associated with plant or animal borne pests and diseases, additives, contaminants, toxins and disease-causing organisms in foods, beverages or feedstuffs. The rules and procedures in the SPS Agreement require that sanitary and phytosanitary measures address legitimate human, animal and plant health concerns, do not arbitrarily or unjustifiably discriminate between WTO members' agricultural and food products, and are not disguised restrictions on international trade. The SPS Agreement requires that the measures in question be based on scientific grounds and developed through risk assessment procedures, while at the same time it preserves each member's right to choose the level of protection it considers appropriate with regard to sanitary and phytosanitary risks.

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

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

Overall, while progress was achieved in some contentious areas in 2004, China's compliance efforts in the agriculture sector continued to produce mixed results, as in prior years. According to one trade association, "[t]ariff reductions . . . have certainly encouraged sales, but increased

imports has largely been the result of greater demand for raw materials such as cotton, hides, and wood products, as well as increased demand for livestock feed and livestock products." On the other hand, this association explained that, "[d]espite record growth, there continues to be substantial impediments to agricultural trade with China. Some have been resolved through negotiations, others remain in force, and new problems can appear overnight. Non-tariff barriers remain the biggest source of frustration to U.S. exporters."

On the positive side, some U.S. agricultural products continued to experience dramatic increases in sales to China, while others showed substantial increases for the first time in 2004. China is now the United States' fourth largest agricultural export market, as U.S. exports to China totaled $4.1 billion from January through September 2004, representing a 44 percent increase over the same period in 2003, a very successful year. Indeed, in 2003, U.S. exports exceeded $5.4 billion, more than twice the level in 2002 and more than five times the level in 1999. In addition, during the run-up to the April 2004 JCCT meeting, China addressed one of the most troublesome problems of 2002 and 2003 – the requirements of China's biotechnology regulations – by issuing final safety certificates for U.S. soybeans and several other products in early 2004. Near the end of the year, China also lifted a ban on U.S. poultry exports that had been imposed because of outbreaks of Avian Influenza (AI) and was preparing to lift a ban on non-risk bovine products, which China had included in the larger banning of U.S. beef following the discovery of bovine spongiform encephalopathy (BSE) in a cow imported into the United States from Canada.

Nevertheless, serious problems continued to be encountered on many fronts. The key problems involved the non-transparent application of sanitary and phytosanitary measures, which seemed to have no scientific basis and impeded market access for many U.S. agricultural products, as well as inspection-related requirements. In addition, despite some progress, China's administration of TRQs on bulk agricultural commodities was still not functioning entirely as envisioned in China's WTO accession agreement, as it continued to be impaired by inadequate transparency.

In 2005, the United States will continue to pursue vigorous bilateral engagement with China in order to obtain progress on its outstanding concerns. As part of this effort, the United States will use a new high-level U.S.-China working group, created at the April 2004 JCCT meeting as a vehicle to address each side's concerns in the agriculture area.

### *Tariffs*

China implemented the required tariff changes on agricultural goods for 2004 on schedule on January 1, 2004, just as it did for industrial goods. These tariff changes further increased market access for many U.S. agricultural exporters, as China continued the scheduled reduction of tariff rates on agricultural goods of greatest importance to U.S. farmers and ranchers from a 1997 average of 31 percent to 14 percent, in almost all cases over a period of five years running from January 1, 2002.

The tariff reductions made by China contributed to a marked increase in certain U.S. exports to China, some of which were also aided by increased demand. Exports of some bulk agricultural commodities increased dramatically, particularly cotton and wheat (see Tariff-rate Quotas on Bulk Agricultural Commodities section below), while exports of soybeans continued to perform strongly (see China's Biotechnology Regulations section below). 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.

However, not all of China's tariff cuts resulted in improved market access in 2004. As discussed below, because of problems that arose with some non-tariff barriers, market access for many U.S. agricultural products was still impeded.

***China's Biotechnology Regulations***

One of the most contentious agriculture issues that arose during China's first year of WTO membership involved new rules implementing June 2001 regulations relating to biotechnology safety, testing and labeling. The implementing rules, issued by China's Ministry of Agriculture (MOA) shortly before China's WTO accession, did not provide adequate time for scientific assessment and the issuance of final safety certificates for biotechnology products. As the March 2002 effective date for these implementing rules approached, trade in biotechnology products began to be disrupted. The U.S. products most affected were soybeans, which had seen exports to China grow to more than $1 billion in 2001, while corn and other commodities, such as consumer products made from biotech commodities, remained at risk. Following concerted, high-level pressure from the United States, China agreed to a temporary solution in March 2002, which provided for a nine-month delay, effected through the issuance of temporary safety certificates, good though December 20, 2002. When it became apparent that this extension would not be sufficient, further high-level engagement produced another agreed extension until September 2003.

In early 2003, it became clear that China would not be in a position to issue final safety certificates by September 2003. As a result, following further high-level meetings, China agreed to extend the interim agreement through April 2004. In the Fall of 2003, the United States again urged China to issue final safety certificates in a number of high-level meetings, including the November 2003 Trade Dialogue meetings, in an effort to ensure that further trade disruptions were avoided. In December 2003, China announced that it would issue final safety certificates by February 2004.

As promised, China issued a final safety certificate for a U.S. biotech soybeans known as Roundup Ready soybeans in February 2004. In addition, by the time of the April 2004 JCCT, China had also issued final safety certificates for seven corn events, seven canola events and two cotton events, leaving only one corn event still awaiting final approval. The Ministry of Agriculture has indicated that action on the remaining corn event can be expected by early 2005.

With some stability added to the China soybean market through the extensions in 2003 and the issuance of the final safety certificate for Roundup Ready soybeans in February 2004, U.S. exports of soybeans remained strong. In 2003, they reached a record level of $2.9 billion, representing an increase of 190 percent over 2002. Meanwhile, from January through September of 2004, U.S. soybean exports totaled $929 million, a decrease of 23 percent when compared to the same period in 2003, although China remained the leading purchaser of U.S. soybeans.

Meanwhile, other U.S. concerns with China's biotechnology regulations and implementing rules remain, particularly with regard to risk assessment, labeling and field trials. These issues are being discussed by a high-level U.S.-China working group, formed in July 2002. In addition, a newly created sub-group of experts focuses on specific, technical issues. Together, these two groups have made substantial progress, and they will continue to work through the range of issues in 2005.

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

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

As previously reported, when initially setting up its TRQ system for 2002, SDPC issued flawed regulations. They did not provide for the required transparency, imposed burdensome licensing procedures, and appeared to contravene agreed rules in China's accession agreement by establishing a separate sub-quota for the processing and re-export trade. Then, once implementation began, all of the available information indicated that SDPC had decided to allocate TRQs in a manner that would protect domestic farm interests and maintain the monopoly enjoyed by state trading enterprises. SDPC operated with only limited transparency, refusing to provide specific details on the amounts and the recipients of the allocations. At the same time, SDPC reserved a significant portion of the TRQs for the processing and re-export trade, despite China's commitment to provide market access and national treatment for imported products. SDPC also allocated a portion of the TRQs for some commodities in smaller than commercially viable quantities, and it employed burdensome licensing requirements.

As these problems became apparent in the first several months of 2002, the United States repeatedly engaged China bilaterally, at all levels of government, and it also raised its concerns at

the WTO during meetings of the Committee on Agriculture. In July 2002, the United States requested formal consultations with China under the headnotes contained in China's WTO goods schedule, which took place in September 2002 in Geneva.

Subsequently, SDPC's performance improved in certain respects. SDPC was able to complete the required re-allocation of 2002 TRQs in a timely manner, and it issued 2003 TRQs close to the prescribed time. Nevertheless, the United States remained concerned, particularly because 2002 trade data showed extremely low fill-rates for the TRQ commodities of the most interest to U.S. industry. The fill-rates for wheat, corn and cotton were 7 percent, 0.1 percent and 22 percent, respectively.

Following the 2003 TRQ allocations, it became clear that the most serious first-year problems – lack of transparency, sub-division of the TRQ, small allocation sizes and burdensome licensing – persisted. The United States again engaged China bilaterally on several occasions, culminating with high-level meetings in Beijing in June 2003. At these meetings, China agreed to take steps to address most of the United States' concerns. Meanwhile, the 2003 fill-rates for wheat, corn and cotton ended up at 5 percent, 0.1 percent and 102 percent, respectively.

China followed through on its June 2003 commitments in part in October 2003, when NDRC issued new regulations for shipments beginning January 1, 2004. Key changes made by these regulations include the elimination of separate allocations for general trade and processing trade, the elimination of certain unnecessary licensing requirements, and the creation of a new mechanism for identifying allocation recipients.

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

While these systemic changes were taking place, exports of some bulk agricultural commodities from the United States continued to show substantial increases, largely due to market conditions. In particular, despite some 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.

The United States continued to raise transparency and other concerns in 2004, both in bilateral meetings and during the transitional review before the Committee on Agriculture in September 2004. In 2005, the United States will continue to work to ensure that NDRC administers TRQs

in a manner that is consistent with China's commitments, transparent and in a manner that does not impede market access or commercial decisions.

***Sanitary and Phytosanitary Issues***

Over the last year, China subjected U.S. agricultural exports to an increasing number of SPS measures that raised WTO concerns. Two new ones involved BSE and AI.

In December 2003, China and other countries imposed bans on U.S. bovine products in response to a case of BSE found in the United States. 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 (i.e., porcine, poultry, etc.) 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 early December 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 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.

Meanwhile, while the 1999 U.S.-China Agricultural Cooperation Agreement established an agreed level of TCK fungus tolerance in U.S. wheat, and China no longer routinely blocks U.S. wheat exports from the Pacific Northwest on the basis of the TCK fungus, 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 (see Tariff-rate

Quotas on Bulk Agricultural Commodities section above), as China does not appear to be enforcing them.

With regard to raw poultry and meat, China continues to apply certain standards that do not appear to be based on scientific evidence, which has had 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, contrary to WTO national treatment principles.

Another problematic area involves China's overly restrictive food additive standards. China continues to block many U.S. processed food products from entering the Chinese market by banning certain food additives that are widely used in other countries and have been approved by the World Health Organization.

In 2004, as in prior years, the United States repeatedly engaged China on these and other SPS issues, both in bilateral meetings, including high-level meetings, and during meetings of the WTO's SPS Committee and Council for Trade in Goods, including the transitional reviews held in October and November 2004. The United States also provided technical assistance to China's regulatory authorities. To date, however, little progress has been achieved, except in the case of the BSE and AI bans. The United States will continue to press for resolution of these issues in 2005.

Finally, in August 2003, as previously reported, AQSIQ announced plans to suspend soybean imports from four companies trading U.S. soybeans, along with companies from Argentina and Brazil. According to AQSIQ, this action was based on detections of Phytophthora sojae in shipments of soybeans beginning in the Spring of 2003. The United States immediately raised serious concerns with this announcement in a series of high-level meetings. Not only was there no apparent legitimate purpose for AQSIQ's delay in making the announcement, but also it is unusual for an inspection and quarantine agency not to set a date upon which a suspension would take place. These circumstances suggested that AQSIQ's intent was to disrupt the importation of U.S. soybeans, and not to address a legitimate phytosanitary concern. Indeed, the presence of Phytophthora sojae in soybeans is ubiquitous in many parts of the world, including China itself. In September 2003, China agreed to technical level meetings of U.S. and Chinese agricultural experts (which took place in mid-December 2003), and in the interim it committed not to impose any suspensions. In 2004, this issue did not appear to have had any effect on U.S. exports of soybeans to China.

### *Inspection-related Requirements*

The United States continues to have concerns about AQSIQ's administration of import licensing procedures. As in 2002 and 2003, U.S. exporters are complaining about AQSIQ's arbitrary use

of inspection-related requirements to restrict, delay and increase the cost of U.S. agricultural exports, particularly commodities like soybeans, cotton, meat and poultry.

Two AQSIQ measures – the *Administrative Measures for the Entry-Exit Inspection and Quarantine for Grains and Feed Stuff*, which became effective on March 1, 2002, and the *Administrative Measures for Entry Animal and Plant Quarantine*, which became effective September 1, 2002 – require importers to obtain an import inspection permit or a quarantine inspection permit for many agricultural goods before they can enter China, such as livestock, poultry, grains, oilseeds, planting seeds, horticultural products, and hides and skins. U.S. exporters have reported 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 selective enforcement by AQSIQ.

The United States sought to resolve its concerns in bilateral meetings with China in 2002 and 2003, including the February and November 2003 Trade Dialogues. The United States also raised its concerns during meetings of the Committee on Agriculture, the SPS Committee and the Import Licensing Committee, including the transitional reviews conducted in 2002 and 2003. Some progress appeared to have been achieved in early 2003, as China discontinued arbitrary limits on imported poultry and pork shipments. However, many concerns raised by the United States were not addressed, and the United States continued to seek resolutions in 2004.

In June 2004, fulfilling a Chinese commitment made in connection with the April 2004 JCCT meeting, AQSIQ issued a new decree (known as Decree 73), the *Items on Handling the Review and Approval for Entry Animal and Plant Quarantine*, 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.

The United States welcomed both of these developments, although 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. The United States engaged China bilaterally, through a series of meetings during the last half of 2004, and multilaterally, during the transitional reviews before the Committee on Market Access, the SPS Committee and the Council for Trade in Goods in September, October and November 2004, in an effort to address these concerns. 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 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.

***Export Subsidies***

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

The United States raised concerns about possible export subsidies on corn with China in bilateral meetings throughout 2002 and 2003, including the Trade Dialogues held in February and November 2003. It also sought information about China's corn policies during meetings before the Committee on Agriculture, including the transitional reviews held in September 2002 and September 2003. However, it proved difficult to develop the necessary evidence to confirm that China was subsidizing its corn exports.

In 2004, trade analysts have begun 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. One result appeared to be that China's exports were made on a commercial basis in 2004.

The United States will continue to investigate China's subsidies practices in the agriculture area in 2005 and will make every effort to ensure that any use of export subsidies is eliminated.

**Intellectual Property Rights**

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

Overall, China's efforts to bring its framework of laws, regulations and implementing rules into compliance with the TRIPS Agreement have been largely satisfactory, although some improvements still need to be made. Enforcement of these measures, however, remained ineffective in 2004. Indeed, some U.S. rights holders reported that IPR infringement worsened in 2004, and the United States used high-level meetings to strongly urge China to take immediate and substantial steps to put it on the path toward compliance with its critical TRIPS Agreement obligation to make available effective enforcement mechanisms.

China had taken an important step forward in October 2003 when it constituted a new IPR Leading Group, signaling a more focused and sustained effort by China to tackle the IPR enforcement problem. Vice Premier Wu, the Chair of this group, acknowledged at an OECD-China IPR Workshop in early 2004 that "[t]here are still problems and challenges in the development process of IPR protections in China. But," she emphasized, "the government is resolute about improving the IPR system . . . and effectively protecting intellectual property rights. To this end, China is ready to learn from the experiences of other countries and international organizations . . . ."

The United States made IPR enforcement its highest priority during the run-up to the April 2004 JCCT meeting, as it emphasized its serious concerns in a series of high-level meetings in Washington and Beijing. China announced a comprehensive action plan on IPR enforcement when the JCCT convened, 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 World Intellectual Property Organization (WIPO) Internet-related 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.

U.S. companies and trade associations welcomed the progress made through the April 2004 JCCT meeting and expressed the hope that China's action plan would be fully implemented. The president of an association representing many U.S. businesses operating in China stated that "[t]he agreements reached at the April meetings in Washington . . . , if fully lived up to in the months and years to come, are important indicators that continuing U.S.-China engagement can result in successful agreements of great importance to China's WTO standing and to the interests of U.S. companies, workers and communities."

Since the April 2004 JCCT meeting, several bilateral meetings have taken place, as the United States has pressed China to move forward aggressively in pursuit of significantly reduced IPR infringement levels. The United States also raised its concerns forcefully at the WTO during the transitional review conducted by the Council for Trade-related Aspects of Intellectual Property Rights (TRIPS Council) in December 2004.

In the months following the April 2004 JCCT meeting, Vice Premier Wu pledged that China would move forward with the legislative and judicial measures needed to improve China's IPR protection regime. Vice Premier Wu also made clear that China would turn its attention to educating consumers and enforcing laws already in place. In August 2004, at the Xiamen China International Fair for Investment and Trade, Vice Premier Wu proclaimed that China would soon launch a year-long campaign targeting IPR infringement that would focus on import/export activities, trade fairs and exhibitions, distribution, brand name processing trade and publishing. She explained that this campaign would proceed in three phases: (1) planning and mobilization (September 2004); (2) implementation (October 2004 to June 2005); and (3) summary (July to August 2005). This campaign, intended to implement China's JCCT commitments to conduct nation-wide enforcement actions and educate the public about IPR, seeks to integrate the work of multiple government agencies to combat IPR abuses in fifteen provinces and cities designated for priority action. U.S. companies have welcomed this display of China's determination to curb IPR abuses.

In early 2005, the United States will conduct an out-of-cycle review under the Special 301 provisions of U.S. trade law. This review will examine China's progress in implementing the action plan that Vice Premier Wu announced at the April 2004 JCCT meeting with the stated intent of significantly reducing IPR infringement levels in China. In preparation for this review, USTR has initiated a systematic evaluation of China's entire IPR enforcement regime and has also asked U.S. manufacturers and businesses to document IPR infringement to the extent possible. The United States is prepared to take whatever action is necessary at the conclusion of this review to ensure that China develops and implements an effective system of IPR enforcement, as required by the TRIPS Agreement.

***Legal Framework***

At the time of its accession to the WTO, China was in the process of modifying the full range of IPR laws, regulations and implementing rules, including those relating to patents, trademarks and copyrights. China had completed amendments to its patent law, trademark law and copyright law, along with regulations for the patent law. Within several months after its accession, China issued regulations for the trademark law and the copyright law. China also issued various sets of implementing rules, as well as regulations and implementing rules covering specific subject areas, such as integrated circuits, computer software and pharmaceuticals.

As previously reported, U.S. experts carefully reviewed China's new IPR laws, regulations and implementing rules and, together with other WTO members, participated in a comprehensive

review of them as part of the first transitional review of China before the TRIPS Council in 2002. In 2003, China issued several new measures in the patent, trademark and copyright areas, which were reviewed during the transitional review before the TRIPS Council in November 2003. While this process identified various areas where China could make improvements, and the United States and U.S. industry continue to press China to do so, overall the legal changes made by China through 2003 were major improvements that moved China generally in line with international norms in most key areas.

In the trademark area, some progress was made this year on the recognition of foreign well-known marks, more than a year after the issuance of implementing rules on well-known marks. A handful of foreign marks have been recognized as well-known, all in the last year. The Trademark Administration also announced plans to amend its *Regulations on Trademark Administrative Enforcement* later this year in order to guide regional industrial and commercial administrations in facilitating effective trademark enforcement and protection. In addition, in November 2004, six Chinese provinces signed an agreement to establish an IPR alliance, with a focus on the trademark area. Intellectual property bureau directors of Shanxi, Henan, Anhui, Jiangxi, Hubei and Hunan signed the Agreement on IPR Development and Cooperation Mechanism in Six Central Provinces pledging the establishment of an inter-province administrative law enforcement mechanism, the opening of a central-six regional economic development and IPR strategy website, and the establishment of an IPR development coordination leading small group. Many local governments are also reportedly drafting their own action plans to further implement China's commitment to significantly reduce IPR infringement levels.

With regard to copyright protection over information networks, China is currently drafting revisions to its 2001 Internet-related implementing rules to provide better IPR protection on the Internet. This development is welcomed by the U.S. Government as a concrete step in line with China's JCCT commitments to improve protection of electronic data and apply criminal sanctions to on-line piracy. U.S. companies also welcome this step because loopholes in those rules have allowed copyright infringement on the Internet to become a growing phenomenon in China. In addition, at the provincial and local levels, a number of initiatives have been undertaken. In November 2004, the State Intellectual Property Office and MII jointly organized a hearing on their *Draft Measures on Administrative Protection of Internet Information Broadcasting Rights*. These draft implementing rules would require Internet service providers to take remedial actions to delete contents that infringe on copyrights upon receipt of a complaint from the right holder, or face administrative penalties ranging from confiscation of illegal gains to fines of up to RMB 100,000 ($12,060). The implementing rules are expected to be issued by the end of this year. Meanwhile, the State Council Legislative Affairs Office put a separate – and likely more authoritative – measure, the *Regulations on the Protection of Copyright Over Information Networks*, on its 2005 legislative agenda.

MOF and other relevant agencies are currently drafting regulations on government procurement of software that require central government departments to use only legitimate software products

and encourage agencies to add funds to their budgets to cover legitimate software purchases. These draft regulations directly address China's JCCT commitment to extend an existing ban on the use of pirated software in central, provincial and local government agencies. Recently, the central government authorized the National Copyright Administration to conduct audits of central government offices in an effort to ensure that only legal software is deployed. In addition, Vice Premier Wu directed all provincial-level agencies to begin using only legal software by the end of 2004. Several provincial governments and the governments of Shanghai, Beijing, Guangzhou and Zhejiang, among other municipalities, have also taken steps toward ensuring that only legal software is used within their agencies.

Meanwhile, by the end of its third year of WTO membership, China still had not acceded to the 1996 WIPO Internet-related treaties, which entered into force in 2002 and have been ratified by many developed and developing countries. Although China is not obligated under WTO rules to accede to the WIPO treaties, the United States considers these treaties to reflect international norms for providing copyright protection over the Internet. While China's existing regulations and implementing rules do address certain copyright issues related to the Internet, and China is in the process of drafting further revisions, the United States has urged China for some time to accede to the WIPO treaties and fully harmonize its regulations and implementing rules with them. At the April 2004 JCCT meeting, China agreed to ratify and implement the WIPO treaties as soon as possible, although it has not yet done so.

With regard to China's JCCT commitment to increase border measures protecting against the import and export of infringing products and to make it easier for rights-holders to secure effective enforcement at the border, a series of new Customs Administration regulations and implementing rules have been issued this year. Earlier this year, the Customs Administration issued the *Regulations on Customs Protection of Intellectual Property Rights*, which went into effect in March 2004. The Customs Administration subsequently issued implementing rules for these regulations, effective July 2004. These new regulations and implementing rules address the duties of the Customs Administration and improve guidance on the implementation of the customs IPR recordal mechanism. In other areas, however, the new regulations and implementing rules lack clarity or could benefit from further changes, such as with regard to the storage and disposition of infringing goods and the transferral of cases for possible criminal prosecution.

***Enforcement***

The TRIPS Agreement requires China to implement effective enforcement procedures and to provide civil and criminal remedies that have a deterrent effect. Although the central government displayed strong leadership in modifying the full range of China's IPR laws and regulations in an effort to bring them into line with China's WTO commitments, effective IPR enforcement has not been achieved, and IPR infringement remains a serious problem throughout China. IPR enforcement is hampered by lack of coordination among Chinese government ministries and agencies, local protectionism and corruption, high thresholds for criminal prosecution, lack of training and weak punishments.

In 2002, one trade association explained that "[e]ffective enforcement against [IPR] infringement in China is universally recognized as the chief concern of [IPR] rights-holders, as piracy rates in China in all areas, including copyright, trademark and patents, continue to be excessively high." This statement was consistent with figures released by the State Council's Development Research Center in July 2003, which showed that the market value of counterfeit and pirated goods in China was between $19 billion and $24 billion in 2001, translating into enormous losses for IPR rights-holders.

In 2004, nearly three years after China's accession to the WTO, U.S. rights-holders uniformly report that IPR infringement in China is rampant, and some witnesses testified at the TPSC hearing held in September 2004 that the situation has actually worsened. One U.S. trade association reports that "[c]ounterfeiting and piracy [in China] remain among the highest in the world – more than 90 [percent] of virtually every form of intellectual property." Current estimates of U.S. losses due to the piracy of copyrighted materials alone range between $2.5 billion and $3.8 billion annually. As one association executive explained, "[l]ack of transparency and coordination among government agencies, local protectionism and corruption, high thresholds for criminal prosecution, and lack of resources and training all hinder enforcement."

IPR infringement in China in 2004 continued to affect products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, consumer goods, electrical equipment, automotive parts and industrial products, among many others. 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.

The United States places the highest priority on addressing IPR enforcement problems in China, and in 2004 it devoted additional staff and resources, both in Washington and in Beijing, to address these problems. While a domestic Chinese business constituency is increasingly active in promoting IPR enforcement, it is clear that there will continue to be a need for sustained efforts from the United States and other WTO members, along with the devotion of considerable resources and political will to IPR enforcement by the Chinese government, if significant improvements are to be achieved on this front.

In Beijing, Shanghai and other localities in 2004, authorities did crack down on certain marketplaces known for selling counterfeit and pirated goods. For example, both the Beijing and Shanghai Industrial and Commercial Administrations issued bans on certain designated famous trademark products in these marketplaces, facilitating more direct and rapid enforcement against these products, all of which are presumed to be counterfeit. Nevertheless, while local measures are desirable, a cohesive central, provincial and local enforcement scheme is necessary to effective reduction of IPR infringement.

Since China issued its new IPR laws, regulations and implementing rules, the United States has worked with central and local government officials in China in a determined and sustained effort to improve China's IPR enforcement. A variety of U.S. agencies have held regular bilateral discussions with their Chinese counterparts and have conducted numerous technical assistance programs for central and local government officials on TRIPS Agreement rules, IPR enforcement and rule of law issues. In addition, the United States has organized annual roundtable meetings in Beijing designed to bring together U.S. and Chinese government and industry officials. The United States' effort has also benefitted from cooperation with Japan and other WTO members to seek improvements in China's IPR enforcement, both on the ground in China and at meetings of the TRIPS Council.

In addition, the United States has worked to block counterfeit and pirated goods at the U.S. border. Since 2000, seizures of counterfeit and pirated goods at U.S. land borders and seaports are up 100 percent. The number of U.S. International Trade Commission proceedings instituted to enforce intellectual property rights and to prevent imports of infringing goods from China and other countries is up 65 percent over the last four years, when compared to the previous four years. Morever, in October 2004, the United States announced the most comprehensive initiative ever advanced to combat the multi-billion dollar global trade in counterfeit and pirated goods. Developed over the preceding year, the Strategy Targeting Organized Piracy (STOP!) is a U.S. government-wide effort 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.

Below, the three different mechanisms for IPR enforcement created by China's IPR laws and regulations – enforcement by administrative authorities, criminal prosecutions and civil actions for monetary damages – are examined. As the United States and other WTO members have been urging, China needs to take immediate steps to improve each of these enforcement mechanisms, particularly criminal enforcement, if China is to even approach the minimum standards for IPR enforcement established by the TRIPS Agreement.

Administrative Enforcement

China continues to take a large number of administrative enforcement actions against IPR violators. However, they are not having a deterrent effect.

Although the central government continues to promote periodic anti-counterfeiting and anti-piracy campaigns, and these campaigns result in high numbers of seizures of infringing materials, they are largely ineffective. For one thing, the cases subsequently brought by the administrative authorities usually result in extremely low fines. When the administrative authorities decide on fines, the fine amounts are kept artificially low because many administrative

authorities do not treat the infringing goods as having the value of the genuine articles, but rather establish value based on the price charged for the counterfeit or pirated goods. 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 September 2004, the Customs Administration issued new regulations on administrative penalties in the customs context, the *Implementing Regulations for the Imposition of Administrative Penalties by the General Administration of Customs*, effective November 1, 2004. In an apparent improvement over the prior regulations, these new regulations do not impose a "knowledge" requirement before penalties can be imposed. However, the new regulations provide for fines not to exceed 30 percent of the value of the goods confiscated, or RMB 50,000 ($6,030), whichever is lower. In contrast, the prior regulations allowed for fines up to the full value of the goods confiscated. The fines allowed under the new regulations are also lower than those imposed by other Chinese agencies focusing on domestic IPR infringement.

The Customs Administration has also developed an IPR action plan calling for increased enforcement over exports of infringing goods, in conformity with China's JCCT commitments. At least one port (Ningbo) has significantly increased resources by creating an expert team to implement the work plan, resulting in an increase in inspections. According to the Customs Administration, under this initiative, inspections have increased by 300 percent, as the amount of shipments inspected has risen from about 2 percent to between 6 and 7 percent.

In bilateral meetings with China throughout 2004, the United States continued to emphasize that China needs to revise its IPR legal framework to provide for substantially higher administrative fines, and the administrative authorities then need to impose and publicize them so they will have a deterrent effect, including facilitating referrals for criminal prosecution.

Criminal Enforcement

In the view of the United States and U.S. industry, the most critical steps for China to take in improving its IPR enforcement are in the criminal area. Effective criminal enforcement offers the deterrence needed for China to begin to handle the rampant IPR infringement hurting both foreign and domestic enterprises. For this reason, the United States sought and obtained at the JCCT meeting a commitment by China to apply criminal sanctions to a wider range of IPR-infringing activities and to increase the penalties for IPR violations.

At present, criminal enforcement has virtually no deterrent effect on infringers. China's authorities have pursued criminal prosecutions in a small number of cases, and a lack of transparency makes it sometimes difficult to find out if they resulted in convictions and, if so, what penalties were imposed. If this situation is to change, China needs to revise its laws, regulations and other measures, including judicial interpretations, and investigate, prosecute, convict and sentence a much higher percentage of IPR infringers, particularly those engaged in commercial-scale counterfeiting or piracy and repeat offenders. China also needs to increase the criminal penalties available.

Partly because of these weaknesses in China's laws and regulations, China rarely pursues criminal prosecutions. While the Customs Administration reported in November 2004 that it had referred two cases involving U.S. rights-holders to the Ministry of Public Security for criminal prosecution, U.S. companies continued to complain that, in most regions of China, the police are either not interested in pursuing counterfeiting and piracy cases or simply lack the resources and training required to investigate these types of cases effectively. In addition, in some circumstances, it is not clear under China's laws and regulations whether a particular activity warrants administrative, civil or criminal enforcement. When that happens, criminal enforcement is not pursued. Moreover, even when IPR violations are referred for criminal enforcement, the actual prosecution of IPR crimes frequently requires coordination among a relatively large number of agencies at the national and local levels. Coordination remains problematic, however, with different agencies using different standards to determine whether criminal conduct exists and some agencies apparently unwilling or unable to work together.

One critical legal change that is needed involves criminal liability thresholds. At present, these thresholds are very high and seldom met. Under a Supreme People's Court interpretation, in order to bring a criminal action against an alleged infringer, there must be evidentiary proof of sales totaling RMB 200,000 ($24,100) for enterprises and RMB 50,000 ($6,030) for individuals. This proof-of-sale requirement has been unworkable, as it does 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. The proof-of-sale requirement is also misguided, as the amount of counterfeit or pirated goods sold should only be relevant to the severity of the penalty imposed, not to the decisions to investigate, prosecute or convict. In its accession agreement, China committed that its administrative authorities would work with the Supreme People's Court in an attempt to address these concerns, but this work seems to have been stalled this year.

At the April 2004 JCCT meeting, China pledged that, by the end of this year, it would issue judicial interpretations that lower the value thresholds that trigger criminal investigations and prosecutions, and that apply criminal sanctions to the import, export, distribution and storage of counterfeit goods as well as to on-line piracy. At present, China is still drafting these judicial interpretations. However, despite multiple requests, China has so far refused to share any drafts of the judicial interpretations, while reiterating its commitment to issue them by the end of this year. The United States will continue to press China to circulate the proposed judicial

interpretations for public comment, in accordance with the transparency commitments in China's WTO accession agreement. The United States will also closely monitor how China implements the judicial interpretations in 2005.

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**

The commitments that China made in the services area begin with the General Agreement on Trade in Services (GATS). The GATS provides a legal framework for addressing market access and national treatment limitations affecting trade and investment in services. It includes specific commitments by WTO members to restrict their use of those limitations and provides a forum for further negotiations to open services markets around the world. These commitments are contained in national services schedules, similar to the national schedules for tariffs.

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

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

commitments made by China in its services schedule, that company could continue to operate with those rights.

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

As the third year of China's WTO membership nears its completion, challenges remain in securing the benefits of these commitments. According to a trade association with broad representation among U.S. service suppliers, "[f]oreign companies are . . . seeking a more consistent approach from China in meeting its WTO obligations. . . . [I]mplementation remains uneven, and, in many instances, unrealized in key areas, including . . . market access for key services sectors." This trade association also cautioned that "the U.S. business community continues to harbor significant concerns over the role of state intervention in designated strategic sectors of China's economy. China's inability to establish independent regulators in the telecommunications and express delivery services sectors is symptomatic of continuing resistance within the government to fully divorce itself from key decision making that affects the commercial environment for both foreign and domestic companies."

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 foreign suppliers from gaining market access. For example, despite some progress, excessive capital requirements 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.

Progress was made on some fronts in 2004, however. For example, China lifted geographic restrictions in the banking and insurance sectors on schedule. In addition, the licensing process in many sectors has proceeded in a workman-like fashion. Indeed, every U.S. insurer that has applied to enter the China market has now received a license, while licenses are beginning to be granted to U.S. and other foreign institutions in the non-bank motor vehicle financing sector. Meanwhile, the new *Administrative Licensing Law*, which took effect on July 1, 2004, should increase transparency in the licensing process, while reducing procedural obstacles and strengthening the legal environment for domestic and foreign enterprises. 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.

Meanwhile, China went beyond its WTO commitments when it entered into bilateral aviation and maritime agreements with the United States.

***Financial Services***

Banking

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

In its accession agreement, China committed to a five-year phase-in for banking services by foreign banks. Specifically, China agreed that, immediately upon its accession, it would allow U.S. and other foreign banks to conduct foreign currency business without any market access or national treatment limitations and conduct local currency business with foreign-invested enterprises and foreign individuals, subject to certain geographic restrictions. The ability of U.S. and other foreign banks to conduct domestic currency business with Chinese enterprises and individuals is to be phased in. Within two years after accession, foreign banks will be able to conduct domestic currency business with Chinese enterprises, subject to certain geographic restrictions. Within five years after accession, foreign banks will be able to conduct domestic currency business with Chinese individuals, and all geographic restrictions will be lifted. Foreign banks will also be permitted to provide financial leasing services at the same time that Chinese banks are permitted to do so.

Shortly after China's accession to the WTO, the People's Bank of China (PBOC) issued regulations governing foreign-funded banks, along with implementing rules, which became effective February 1, 2002. The PBOC also issued several other related measures. Although these measures kept pace with the WTO commitments that China made, it became clear that the PBOC had decided to exercise extreme caution in opening up the banking sector. In particular, it imposed working capital requirements and other prudential rules that far exceeded international norms, both for the foreign banks' headquarters and branches, making it more difficult for foreign banks to establish and expand their market presence in China. For example, the PBOC allowed foreign-funded banks to open only one branch every 12 months.

Initially, in 2002, the PBOC was also slow to act on foreign banks' applications for approval to conduct foreign currency business or local currency business with foreign-invested enterprises and foreign individuals. Beginning in 2003, however, this situation improved noticeably. Currently, a number of foreign banks, including at least 13 U.S. banks, have branches or representative offices

in China, although only major banks have been large enough to satisfy the application requirements.

According to the PBOC, the domestic currency business of U.S. banks grew rapidly in the first two years after China's WTO accession, even though the banks' clients were then limited to foreign-invested enterprises and foreign individuals. Following the PBOC's December 2003 announcement that foreign banks would be permitted to conduct domestic currency business with Chinese enterprises, which keeps pace with China's WTO commitments, the growth in U.S. banks' domestic currency business has accelerated.

In several bilateral meetings since China's WTO accession, the United States has urged the PBOC to reconsider its prudential requirements and to bring them in line with international norms. Together with other WTO members, the United States also raised these same concerns during meetings of the WTO's Committee on Trade in Financial Services, including the transitional reviews held in 2002 and 2003. In December 2003, some progress took place, as the PBOC reduced working capital requirements for various categories of foreign banks by at least RMB 100 million ($12.06 million). Capital requirements for other categories of foreign banks were reduced in July 2004 with the issuance of the *Implementing Rules for the Administrative Regulations on Foreign-Invested Financial Institutions* by the China Banking Regulatory Commission (CBRC). This measure also removed the restriction that had limited foreign-funded banks to opening only one new branch every 12 months. Nevertheless, the United States, along with Australia, Canada, the EC and Japan, continued to urge China to make its banking sector more accessible to foreign banks, as reflected in the transitional review before the Committee on Trade in Financial Services, held in November 2004.

In a measure issued in early December 2004, CBRC opened up five additional cities to foreign banks seeking to conduct local currency business, including two cities (Xian and Shenyang) one year ahead of the commitment in China's Services Schedule. As a result, foreign banks can now conduct local currency business in 18 Chinese cities.

Insurance

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

In its accession agreement, China agreed to phase out existing geographic restrictions on all types of insurance operations during the first three years after accession. It also agreed to expand the ownership rights of foreign companies. Upon accession, foreign life insurers must be permitted to hold 50 percent equity share in a joint venture. Foreign property, casualty and other non-life insurers must be permitted to establish as a branch or as a joint venture with 51 percent foreign

equity share upon accession, and they must be able to establish as a wholly foreign-owned subsidiary two years after accession. In addition, foreign insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance must be permitted 50 percent foreign equity share in a joint venture upon accession, while they must be able to own 51 percent three years after accession and establish as a wholly foreign-owned subsidiary five years after accession. China further agreed that all foreign insurers will be permitted to expand the scope of their activities to include group, health and pension lines of insurance within three years after accession.

CIRC issued several new insurance regulations shortly after acceding to the WTO, including ones directed at the regulation of foreign insurance companies. These regulations implemented many of China's commitments, but they also created problems in three critical areas – capitalization requirements, transparency and branching. In particular, China's capitalization requirements were significantly more exacting than those of other populous countries with no less an interest in preserving a healthy insurance market, and they limited the ability of foreign insurers to make necessary joint venture arrangements. The regulations also 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. Notwithstanding these commitments, the regulations are vague on foreign insurers' branching rights, 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 – and unnecessary – 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 close consultation with U.S. insurers, the United States first raised these issues in 2002 in several bilateral meetings with CIRC, MOFTEC and the State Council and at WTO meetings, with support from Canada, the EC, Japan and Switzerland. Following high-level bilateral meetings during the run-up to the October 2002 Summit between Presidents Bush and Jiang, China began to show some flexibility. CIRC agreed to establish a working group, composed of U.S. regulators and insurers, to discuss insurance issues, with a particular focus on appropriate capitalization requirements and other prudential standards. The first meeting of the working group took place in December 2002.

Following further bilateral meetings in 2003, including the February 2003 Trade Dialogue in Beijing, China issued draft implementing rules in August 2003. Although these draft rules demonstrated some progress with regard to capitalization requirements and transparency, the United States made clear in written comments that more progress was needed. The United

States also continued to press its concerns, particularly with regard to branching, in high-level meetings in Beijing in September and October 2003, during the November 2003 Trade Dialogue meetings, and at the transitional review before the Committee on Trade in Financial Services in December 2003.

CIRC issued final implementing rules, the *Detailed Rules on the Regulations for the Administration of Foreign-Invested Insurance Companies*, in May 2004. 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.

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

As previously reported, CIRC lifted certain geographic restrictions applicable to foreign life insurers ahead of schedule. In 2002, CIRC approved life insurance operations for U.S. insurers in Beijing, Suzhou and Tianjin, two years before China had committed to do so in its Services Schedule. In 2003, CIRC approved life insurance operations for a U.S. insurer in Chongqing nearly one year ahead of schedule. With those moves, China became obligated to provide other life insurers the same access to those cities.

By 2004, the last year in which China can maintain geographic restrictions, the operations of foreign insurers in China had grown quickly. While foreign insurers still had a relatively low share of the national market, they reportedly had captured encouraging market shares in particular localities, such as Shanghai, Guangzhou and Beijing.

At the same time, U.S. and other foreign insurers began to complain in 2004 about another issue, not addressed by the new rules issued in May 2004. 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. The United States expressed concern about this discriminatory treatment during the transitional review before the Committee on Trade in Financial Services in November 2004 and will press China for further information on its branch approval practices in 2005.

In 2005, the United States will continue to seek market access for foreign insurers on a fair and equitable basis. In particular, the United States plans to reconvene its working group with CIRC to discuss the further development of China's insurance sector along the lines envisioned in China's WTO accession agreement. The United States will also continue to urge CIRC not to use its regulatory powers to restrict the access of foreign insurers to China's market.

Motor Vehicle Financing

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

Despite these commitments, China did not open up this sector to foreign financial institutions upon its accession, leaving China's commercial banks as the only financial institutions able to offer auto loans. However, by the end of its second year of WTO membership, China finally issued all of the measures necessary to allow foreign financial institutions to offer auto loans.

As previously reported, the Chinese regulator, the China Banking Regulatory Commission (CBRC), issued long-awaited regulations permitting foreign financial institutions to offer auto loans in October 2003. One month later, CBRC issued implementing rules setting forth the procedures for foreign financial institutions to apply for licenses to begin operations. Although the regulations reduced the capital requirements from the levels set in earlier circulated drafts, they still remain relatively high, as the minimum registered capital is RMB 300 million ($36.2 million), and the minimum paid-in capital is RMB 500 million ($60.3 million).

During the November 2003 Trade Dialogue meetings, the United States urged CBRC to reconsider the high capital requirements and also emphasized the importance of quick action by CBRC on license applications, as U.S. companies were beginning to take steps to obtain licenses to begin operations. In addition, the United States began to work closely with the U.S. companies to ensure that CBRC acted promptly on their applications. In January 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.

In subsequent bilateral meetings and during the transitional review before the Committee on Trade in Financial Services in November 2004, the United States, with support from Australia, Canada, the EC and Japan, continued to urge China to increase market access in this sector, particularly for small and medium-sized enterprises, by lowering the capital requirements established by CBRC's regulations. The United States will continue to press this issue in 2005 and will also work closely with U.S. companies to ensure that CBRC applies all aspects of its new regulations and implementing rules in accordance with China's commitments.

***Legal Services***

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

China's accession agreement provides that, upon China's accession to the WTO, foreign law firms may provide legal services through one profit-making representative office, which must be located in one of several designated cities in China. The foreign representative offices may advise clients on foreign legal matters and provide information on the impact of the Chinese legal environment, among other things. They may also maintain long-term "entrustment" relationships with Chinese law firms and instruct lawyers in the Chinese law firm as agreed between the two law firms. In addition, all quantitative and geographic limitations were to have been phased out within one year of China's accession to the WTO, which means that foreign law firms should have been able to open more than one office anywhere in China beginning on December 11, 2002.

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

In consultation with U.S. law firms, the United States carefully reviewed the new measures and expressed its concerns in written comments in 2002. The United States also held bilateral meetings with China's Ministry of Justice and MOFTEC in 2002 and again in 2003, including during the Trade Dialogue meetings in Beijing in February 2003. In addition, together with the EC and other WTO members, the United States presented its concerns to China in connection with the transitional reviews before the Council for Trade in Services in 2002, 2003 and 2004. 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 problematic aspects of the new measures, particularly the economic needs test, the unreasonable restrictions on the types of legal services that can be provided and the unnecessary delays that must be endured when seeking to establish new offices. The United States will continue to work with China in 2005 in an attempt to resolve these outstanding concerns.

***Telecommunications***

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

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

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

At the same time, China has not yet established a truly independent regulator in the telecommunications sector. The current regulator, MII, while nominally separate from the current telecommunications operators, maintains extensive influence and control over their operations and continues to use its regulatory authority to disadvantage foreign firms.

In April 2003, new problems developed with MII's issuance of the Catalogue of Telecommunications Services. MII reclassified several telecommunications services from the value-added category to the basic category, contrary to widely accepted international practice. MII also placed restrictions on what new services could be classified under the value-added category. These moves have limited the ability of U.S. firms to access China's telecommunications market. Under China's Services Schedule, basic services are on a slower liberalization schedule, and MII subjects them to higher capitalization requirements. Indeed, MII requires suppliers of basic services to satisfy an excessive registered capital requirement of RMB 2 billion ($241.2 million). A review of capital requirements around the world shows essentially no capital requirements in many WTO member markets, including, for example, Argentina, Australia, Brazil, Chile, the member States of the European Union, Japan and the United States.

Where capital-related requirements do exist, they typically take the form of guarantees. For example, Korea requires a $2.5 million bank guarantee or performance bond, while India requires a bank guarantee ranging from $5 million to $80 million, depending on geographic scope.

Meanwhile, MII continues to process applications very slowly for the few foreign-invested telecommunications enterprises that have attempted to satisfy MII's licensing requirements. For example, as China nears the end of its third year of WTO membership, 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.

In 2004, a draft of the long-awaited *Telecommunications Law* began to circulate among Chinese ministries and agencies. The United States and U.S. industry have urged China also to circulate the draft law for public comment. 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.

The United States has repeatedly raised its concerns with China, using both bilateral meetings, including the Trade Dialogues in February and November 2003, and the transitional reviews before the Council for Trade in Services in 2002, 2003 and 2004, where it has received support from the EC and Japan. The United States will continue to press China on these matters in 2005.

***Express Delivery Services***

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

Nevertheless, shortly after becoming a WTO member, China issued two problematic measures. These measures required Chinese and foreign-invested international express delivery companies, including those that were already licensed by MOFTEC to provide international express delivery services (except for the delivery of private letters), to apply for and obtain so-called "entrustment" authority from China's postal authorities, China Post, their direct competitor, if they wanted to continue to provide express delivery services. The measures also placed new weight and rate restrictions on the letters that the companies could handle, assuming that they could obtain entrustment authority, in apparent contravention of China's horizontal "acquired rights" commitment (discussed at the beginning of the Services section).

Working closely with U.S. express delivery companies and other affected WTO members, particularly the EC and Japan, the United States led a sustained effort that eventually convinced China to revise these measures. In September 2002, China issued a new measure, which eliminated the weight and rate restrictions and eased burdensome aspects of the entrustment

application process. In bilateral meetings, China also provided assurances that the regulatory and operational functions of China Post would be split up and that MOFTEC would seek to ensure that China Post did not abuse its regulatory authority. Subsequently, in October 2002, China issued another measure streamlining the entrustment application process even further and effectively eliminated China Post's ability to exercise its discretionary authority to reject entrustment applications from foreign-invested express delivery companies already licensed by MOFTEC. The measure also provided that these companies do not have to apply for separate entrustment certificates for existing or new branches.

In November 2002, U.S. express delivery companies and their Chinese joint venture partners subsequently applied for and obtained the needed entrustment authority from China Post. Since then, they have been able to continue to operate without disruption, while expanding their business operations in China.

In July 2003, however, China began circulating draft amendments to its postal services law, which 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 the ensuing months, U.S. express delivery companies and their joint venture partners submitted written comments to the State Council, which was in charge of the draft amendments, and the United States held a series of bilateral meetings with China.

In September, October and November 2003, the State Council circulated new sets of draft amendments, as written comments continued to be submitted and bilateral meetings continued to take place, including the November 2003 Trade Dialogue in Beijing. While each set of draft amendments included a different definition of the China Post monopoly, the November 2003 draft amendments again provided China Post with a monopoly on letters weighing less than 500 grams. These draft amendments also included other problematic provisions. They appeared to create a new, more burdensome licensing process to replace the existing entrustment process, and they seemed to require express couriers to pay four percent of their revenue from the delivery of letters into a universal service fund.

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

In July 2004, 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. They also did little to address other U.S. concerns.

In bilateral meetings and during the transitional review before the WTO's Council for Trade in Services in November 2004, where it received support from the EC, the United States raised its concerns with the draft amendments. The United States will continue to work closely with U.S. express delivery companies ion 2005 in urging China to issue a sensible and WTO-consistent set of amendments.

*Construction and Related Engineering Services*

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

In September 2002, the Ministry of Construction and MOFTEC jointly issued the *Rules on the Administration of Foreign-Invested Construction Enterprises* (known as Decree 113) and the *Rules on the Administration of Foreign-Invested Construction Engineering Design Enterprises* (known as Decree 114). These decrees provide schedules for the opening up of construction services and related construction engineering design services to joint ventures with majority foreign ownership and wholly foreign-owned enterprises, although to date the necessary implementing rules have only been issued for Decree 113, the construction regulations. 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 require foreign firms to obtain qualification certificates, effective October 1, 2003. In addition, these decrees for the first time require foreign-invested enterprises to incorporate in China, and they impose high minimum registered capital requirements and foreign personnel residency requirements that are difficult for many foreign-invested enterprises to satisfy.

In consultation with U.S. industry, the United States, in a high-level intervention, pressed its concerns about Decrees 113 and 114 and sought a delay before the decrees' problematic requirements would become effective. In September 2003, the Ministry of Construction agreed to extend the implementation date from October 1, 2003 until April 1, 2004. The United States and U.S. industry used this extension to pursue these issues further with the Ministry of Construction and MOFCOM.

In April 2004, Decree 113 went into effect. However, in September 2004, the Ministry of Construction and MOFCOM issued Circular 159, which permitted foreign providers of construction services and related construction engineering design services to continue operating on a project by-project basis until July 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.

Throughout 2004, the United States engaged both the Ministry of Construction and MOFCOM in an effort to obtain improvements in Decree 113. The United States also sought the opportunity to comment on a draft of the implementing rules for Decree 114. The United States will continue to press its concerns in 2005.

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. The United States is currently seeking to clarify this and other aspects of Decree 200.

***Aviation Services***

Even though China made no WTO commitments to open up its aviation services sector, it took a significant step in July 2004 to increase market access for U.S. service providers. China signed a landmark aviation agreement with the United States that will more than double the number of U.S. airlines operating in China and that will increase by five times the number of flights providing passenger and cargo services between the two countries over the next six years. The agreement also allows each countries' carriers to serve any city in the other country, provides for unlimited code-sharing between them, expands opportunities for charter operators, grants cargo carriers the right to provide door-to-door delivery services, and eliminates government regulation of pricing as of 2008. U.S. airlines and U.S. express delivery companies have since obtained additional routes and increased flight frequencies, as envisioned by the agreement.

***Maritime Services***

Even though China made no WTO commitments to open up its maritime services sector, it took a significant step in December 2003 to increase market access for U.S. service providers. The United States and China signed a far-reaching, five-year bilateral maritime agreement, which 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.

### *Other Services*

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

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

In other sectors, however, such as audio-visual services, China has been less willing to increase market access for foreign service providers. Despite the fact that its restrictive approach encourages the illegal copying and sale of foreign films in China, China treats its commitment to allow the importation of 20 foreign films per year for theatrical release on a revenue-sharing basis as a ceiling rather than a floor and further constrains the timely release of these films through distribution and marketing restrictions and lengthy film approval requirements. The United States raised these concerns with China at high levels in 2004 in an attempt to obtain better, and more useful, market access for U.S. service providers. These efforts generated some progress when MOFCOM approved a U.S.-invested film distribution joint venture and took steps to shorten the time required to bring films to market.

Meanwhile, when China issued its revised *Foreign Trade Law* in April 2004, it included a provision that appears to provide broad authority for the imposition of services safeguards. However, the GATS does not provide for a safeguard mechanism, and a safeguard in a scheduled service sector would likely run afoul of China's GATS commitments. In response to concerns raised by the United States and other WTO members, China explained that this provision would only be applied in a way that was consistent with China's WTO obligations.

## Legal Framework

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

***Transparency***

<u>Public Comment</u>

China made a number of transparency commitments in its accession agreement. One of the most important of these commitments concerned the procedures for adopting or revising laws and regulations affecting trade in goods, services, TRIPS or the control of foreign exchange, given that China's accession to the WTO became effective while China was still in the process of revising its trade-related laws and regulations to become WTO-consistent. China agreed to provide a reasonable period for public comment on these new or modified laws and regulations before implementing them, except in certain specific instances, enumerated in China's accession agreement. China also agreed to translate all of its trade-related laws and regulations into one or more of the WTO languages (English, French and Spanish) and to publish them in an official journal.

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

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

In 2004, some improvements took place, particularly on the part of MOFCOM, which began following the rules set forth in its *Provisional Regulations on Administrative Transparency*, issued in November 2003. Those rules could potentially serve as a model for other ministries and agencies seeking to improve their transparency. Nevertheless, basic compliance with China's notice-and-

comment commitment continued to be uneven. 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.

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

In numerous bilateral meetings with the State Council, MOFCOM and other Chinese ministries since China's WTO accession, including high-level meetings, the United States has emphasized the importance of China's adherence to the notice-and-comment commitment in China's accession agreement, both in terms of fairness to WTO members and the benefits that would accrue to China. In addition, the United States continues to provide technical assistance to facilitate Chinese ministries' understanding of the workings, and benefits, of an open and transparent rulemaking process. Together with other WTO members, the United States also raised this issue during regular WTO meetings and as part of the transitional reviews conducted in 2002, 2003 and 2004 before various WTO councils and committees. The United States will continue to work to secure China's full compliance with this fundamental commitment in 2005.

Enquiry Points

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

Official Journal

In its WTO accession agreement, China committed to establish or designate an official journal dedicated to the publication of all laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of foreign exchange. China also committed to publish this journal on a regular basis and to make copies of all issues of this journal readily available to enterprises and individuals. China has yet to either establish or designate an official journal for this purpose. Rather, China currently relies on multiple channels, including ministry websites, newspapers and a variety of journals, to provide information on trade-related measures. The establishment or designation of a single journal would greatly enhance the ability of WTO members to track the drafting, issuance and implementation of trade-related measures. 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. The United States will work with China and other interested WTO members in 2005 to secure China's full compliance with this commitment.

***Uniform Application of Laws***

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

In China's first year of WTO membership, the central government launched an extensive campaign to inform and educate both central and local government officials and State-owned enterprise managers about WTO rules and their benefits. In addition, several provinces and municipalities established their own WTO centers, designed to supplement the central government's efforts and to position themselves so that they would be able to take full advantage of the benefits of China's WTO membership.

In 2002, China also established an internal review mechanism, now overseen by MOFCOM's Department of WTO Affairs, to handle cases of non-uniform application of laws. The actual workings of this mechanism still remain unclear in 2004, however.

During 2004, as in prior years, some problems with uniformity persisted. These problems are discussed above in the sections on Customs and Trade Administration, Taxation, Investment and Intellectual Property Rights.

***Judicial Review***

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

Beginning before China's accession to the WTO, China had taken steps to improve the quality of its judges. For example, in 1999, the Supreme People's Court began requiring judges to be appointed based on merit and educational background and experience, rather than through politics or favoritism. However, existing judges, many of whom have had no legal training, were grandfathered in. In part because of this situation, many U.S. companies in 2004 continued to express serious concern about the independence of China's judiciary. In their experience and observation, Chinese judges are often influenced by political, government or business pressures, particularly outside of China's big cities.

Meanwhile, in 2004, the United States continued to monitor how the courts designated by the Supreme People's Court's *Rules on Certain Issues Related to Hearings of International Trade Administrative Cases*, which went into effect in October 2002, have handled cases involving administrative agency decisions relating to international trade in goods or services or intellectual property rights. So far, however, there is still little data, as few foreign companies have had experience with these courts.

# APPENDIX 1

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

1. U.S.-China Business Council
2. U.S. Chamber of Commerce
3. American Chamber of Commerce-China/American Chamber of Commerce-Shanghai
4. Semiconductor Industry Association
5. U.S. Information Technology Office
6. North American Export Grain Association
7. American Iron and Steel Institute
8. Motor and Equipment Manufacturers Association
9. Coalition of Service Industries
10. Conference of Asia-Pacific Express Carriers/Air Courier Conference of America
11. International AntiCounterfeiting Coalition, Inc.
12. Information Technology Association of America
13. U.S. Council of International Business
14. American Chemistry Council
15. ANSAC
16. California Cherry Advisory Board
17. Ranchers-Cattlemen Action Legal Fund – United Stockgrowers of America
18. U.S. Dairy Export Council/National Milk Producers Federation
19. U.S. Wheat Associates
20. American Forest and Paper Association
21. Distilled Spirits Council of the United States, Inc.
22. United States Motorcycle Manufacturers Association
23. Nintendo of America, Inc.
24. Outdoor Power Equipment Institute
25. U.S.-China Economic and Security Review Commission

# APPENDIX 2

## List of Witnesses
## Testifying at the Public Hearing
## before the Trade Policy Staff Committee
## on China WTO Compliance

Washington, D.C.
September 23, 2004

1. Robert A. Kapp
   President
   US-China Business Council

2. Myron Brilliant
   Vice President, East Asia
   U.S. Chamber of Commerce

3. Jim Gradoville
   Chairman
   American Chamber of Commerce-China
   and
   Jeff Bernstein
   Emerge Logistics on behalf of American Chamber of Commerce-Shanghai

4. Kevin Dempsey
   Dewey Ballantine on behalf of Semiconductor Industry Association

5. Mark Bohannon
   General Council and Senior Vice President for Public Policy
   Software and Information Industry Association
   on behalf of United States Information Technology Office

6. Gary C. Martin
   President and Chief Executive Officer
   North American Export Grain Association

7. Andrew G. Sharkey III
   President and Chief Executive Officer
   American Iron and Steel Institute

8. Scott Meyer
   President
   Motor and Equipment Manufacturers Association

9. Robert Vastine
   President
   Coalition of Service Industries