CHINA'S WTO COMPLIANCE AND INDUSTRIAL SUBSIDIES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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SECOND SESSION

April 4, 2006

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WASHINGTON : June 2006

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

June 15, 2006

The Honorable TED STEVENS
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

We are pleased to transmit the record of our April 4, 2006 hearing on "*China's WTO Compliance and Industrial Subsidies.*" The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, sect. 635(a)) provides the basis for this hearing, as it requires the Commission to study China's compliance with its World Trade Organization (WTO) accession agreement and the effect transfers of U.S. production facilities to China have on the U.S. economy. Representatives from the Office of the U.S. Trade Representative (USTR) and the Government Accountability Office (GAO) and experts from outside the government testified at the hearing.[1]

This testimony addressed how the Chinese government aggressively uses subsidies to promote its economic, technological and political interests. These subsidies include preferential taxation policy, no- or low-interest loans, dual pricing, limits on workers rights and maintaining an undervalued currency in order to develop its economy through government planning rather than allowing it to develop based on market forces. These subsidies exert influence, often negative, on the U.S. economy and particular U.S. industries. Some of these subsidies are actionable under the rules of the WTO.

Identification of Subsidies

According to Loren Yager, Director for International Trade at the GAO, "Chinese subsidies remain very difficult to identify and quantify, largely because of the structure of the Chinese economy and the lack of transparency in the country's subsidy regime." However, panelists did identify several forms of known practices that act as subsidies in the Chinese economy: preferential tax policies, asset injection for state-owned enterprises (SOEs), poor bookkeeping by SOEs, subsidized inputs for SOEs, subsidized energy and land, sectoral credit allocation, the extension of loans without the expectation of repayment, unpaid labor wages, and the undervalued Chinese currency (RMB).

According to Alan Price of Wiley Rein & Fielding LLP, an example of these subsidies and the consequences for the U.S. and world economy is found in the steel industry. China subsidizes its steel industry by 1) transferring facilities at below market prices, 2) providing

[1] An electronic copy of the full hearing record is posted to the Commission's Web Site www.uscc.gov at:. http://www.uscc.gov/hearings/2006hearings/transcripts/april_4/06_04_04_trans.pdf

debt to equity swaps through state-owned banks, 3) providing debt forgiveness through state-owned banks, 4) providing tax benefits for export performance, 5) controlling the prices of raw materials, and 6) maintaining an undervalued RMB. Subsidies such as tax benefits based on export performance are clearly prohibited by WTO rules. Through non-market intervention in the steel industry, the Chinese government has created substantial excess capacity and "has skewed the entire world market for steel and for steel raw material."

While the Commission's hearing was held before China submitted its long overdue subsidies notification to the WTO, the notification does not contribute much to the ability to identify and quantify the full system of subsidies operating in China. Furthermore, as Dr. Usha Haley of the University of New Haven testified, for the majority of subsidies, once identified, the opacity of China's system of subsidies prohibits the necessary information for quantifying the effect of the subsidy and thus, determining whether it is prohibited under the WTO rules. In fact, many of the subsidies cited at the hearing were not present in China's subsidies notification.

Currency Manipulation as a Subsidy

According to most economists, China's currency is overvalued by about 20-40 percent. David Hartquist of Collier Shannon Scott PLLC testified that while China announced last July that it would peg the RMB to a basket of currency rather than the dollar, had it actually allowed it to move based on market forces it would have already reached a revaluation of 40 percent, suggesting the continued manipulation by the Chinese government to undervalue the RMB.

Dr. C. Fred Bergsten, director of the Institute for International Economics, testified that China intervenes in the valuation of its currency by buying $15 billion to $20 billion per month. This intervention by the Chinese government and the resulting currency undervaluation poses serious impediments to U.S. exports to China and acts as a subsidy for their sales to the U.S.

According to Dr. Bergsten, the undervaluation of the RMB and the overvaluation of the dollar hurt U.S. competitiveness in global markets, create large and growing trade and current account deficits,[2] and in the short run decrease job creation and economic growth. On the other hand, he notes there are some benefits. The overvalued dollar keeps the price of imports low, suppresses inflation, and keeps interest rates low. However, he cautions that despite any benefits that may flow from this subsidy, the system is unsustainable.

The panelists agreed that China's undervaluation of its currency acts as a subsidy, but disagreed on whether there is a viable case to be made at the WTO against it. And while it clearly violates IMF commitments, the IMF does not have useful enforcement tools.

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[2] Dr. Bergsten calculates that the U.S. bilateral deficit with China would be reduced by about $1billion for every percent of revaluation of the RMB.

WTO Dispute Settlement

Assistant USTR Stratford testified that demonstrating a willingness to use the WTO dispute settlement mechanism has not hurt our trading relationship with other countries and in fact it helps focus countries involved in a trade dispute on viable solutions. The fact that we've only now brought our second case against China in the WTO is an anomaly. USTR has taken the position that it will bring cases against China to the WTO as long as 1) it is confident the U.S. will win the case, and 2) bringing the case is the most effective way of handling the particular dispute.

USTR recently filed a WTO case against China in the auto parts sector. China had committed to eliminating local content rules for the auto industry in its WTO accession agreement. The U.S. case stipulates that additional Chinese policies enacted after its accession have the same impact as the original local content rules. USTR stated that in one sense these policies could be said to promote import substitution and are therefore a prohibited subsidy, but this is only one of many ways the case could be fought.

The Chinese government's role in the undervaluation of China's currency is also believed by some to be prohibited under WTO rules. According to testimony by Mr. Hartquist a WTO case can be made based on the findings that China's undervalued RMB constitutes a financial contribution, a benefit to exporters in China, and a subsidy based on export performance. However, John Magnus, President of TradeWins LLC, noted that the fact that the undervalued RMB is available to investors, tourists, etc., in addition to exporters, poses problems in proving it is an export subsidy.

Countervailing Duties

The Commerce Department (Commerce) classifies China as a non-market economy (NME). Under such a determination, it is unclear whether Commerce may apply countervailing duties (CVD) to China when industrial subsidies affect China's exports to the U.S. and subsequently injure U.S. industry. According to testimony by the GAO's Loren Yager, Commerce has two ways in which to apply U.S. CVD laws to China: 1) Commerce could reclassify China a market economy or individual industries as market oriented and apply CVDs, or 2) Commerce could reverse its 1984 decision stating it could not apply CVDs to NMEs. However, Mr. Yager stated Commerce takes the position that there is no statutory bar to its application of CVD law to NME's. Additionally, Mr. Magnus contested that there is no legal impediment to applying countervailing duties to NMEs, but he also stated that is no legal reason that Commerce has not produced a test case by applying CVDs to China. That Commerce has not produced a test case, when they contest that they could and U.S. industries have highlighted subsidized Chinese industries exporting to the United States, suggests there are impediments that could be allayed by Congressional action.

Based on GAO's study of the issue, it is unclear in certain cases where relief provided by existing antidumping duties (AD) exceeds the relief of applicable CVDs, whether applying CVDs would provide greater protection than U.S. producers already obtain. Additionally, in cases where both ADs and CVDs are applied, methodological changes are required in the application of both forms of relief by the Commerce Department; as a result, the import relief from the combination often is no greater than when only ADs were applied. However, U.S. producers would directly benefit from the explicit import relief of CVDs, whereas antidumping duties provide indirect relief.

Clarity in the statutory ability to apply CVDs to NMEs would certainly provide an additional tool for U.S. industries injured by Chinese subsidized industries. Currently the Commerce Department uses antidumping duties calculated for NMEs to counter Chinese subsidized industries. The GAO recommended that Congress also provide Commerce the authority to correct situations where double-counting of domestic subsidies occurs "if Commerce applies CVDs to China, while continuing to use its current NME methodology to determine antidumping duties."

Recommendations

Based on information presented at the hearing, we offer the following preliminary recommendations to the Congress.

1. In line with its previous recommendations, the Commission recommends that Congress pursue a five-track policy to spur China to take appropriate action to revalue the RMB:
   - Press the Administration to file a WTO dispute regarding China's exchange rate practices.
   - Press the Administration to respond to China's violation of its international obligations by working with U.S. trading partners to bring to bear on China the resolution mechanisms of all relevant international institutions.
   - Consider imposing an immediate, across-the-board tariff on Chinese imports at the level determined necessary to gain prompt action by China to strengthen significantly the value of the RMB. (The United States can justify such an action under WTO Article XXI, which allows members to take necessary actions to protect their national security. China's undervalued currency has contributed to a loss of U.S. manufacturing, which is a national security concern for the United States.) [3]
   - Reduce the ability of the Treasury Department to use technical definitions to avoid classifying China as a currency manipulator by amending the 1988 Omnibus Trade Act to (i) include a clear definition of currency manipulation, and (ii) eliminate the requirement that a country must be running a material global trade surplus in order for the Secretary of the Treasury to determine that the country is manipulating its currency to gain a trade advantage.
   - Urge the Treasury Department to maintain a high level of pressure on China to take more significant actions expeditiously to revalue its currency and, if such actions are not forthcoming by the time Treasury issues its next exchange rate report, to designate China as a currency manipulator and initiate bilateral and IMF negotiations.

[3] Commissioner Reinsch dissents from this recommendation.

2. USTR testified that bringing WTO cases is helpful in focusing particular trade relationships on beneficial solutions to problems. For this reason, and because the United States is now bringing only its second case against China, the Commission recommends that Congress direct USTR to consider a wider range of possible WTO cases than its current criteria allow.

3. In order to make available a more complete set of remedies to industries injured by Chinese-subsidized companies, and consistent with its previous recommendations with regard to countervailing duties, the Commission recommends that Congress—
   - Enact legislation to make countervailing duties applicable to non-market economies.[4]
   - Repeal the new shipper bonding privilege that has allowed many importers of Chinese goods to avoid payment of antidumping duties. Importers of goods subject to antidumping or countervailing duties should be required to deposit in cash the amount of any estimated applicable duty.
   - Maintain the Continued Dumping and Subsidies Offset Act of 2000 (CDSOA), notwithstanding the WTO determination that it is inconsistent with the WTO Agreement, and press the Administration to seek explicit recognition during the Doha Round negotiations and the review of the WTO's dispute resolution mechanism of the existing right of WTO Members to distribute funds collected from antidumping and countervailing duties.[5]

4. The Commission recommends that Congress direct USTR and the Department of Commerce to engage in a full and careful examination of the completeness of the Chinese Government's recent subsidy notification to the WTO and to present a report to Congress on their findings. The report should provide an inventory of practices not listed by the Chinese that should be considered subsidies.

The transcript, witness statements, and supporting documents for the Commission's hearing can be found on the Commission's website at www.uscc.gov. We hope these will be helpful to you as the Congress continues its assessment of China's compliance with its WTO obligations and its determination of actions the United States should take in order to obtain full compliance.

Sincerely,

Larry M. Wortzel
Chairman

Carolyn Bartholomew
Vice Chairman

Cc: Congressional members and staff

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[4] Commissioner Reinsch dissents from this recommendation.
[5] Commissioner Reinsch dissents from this recommendation.

CONTENTS

TUESDAY, APRIL 4, 2006

CHINA'S WTO COMPLIANCE AND INDUSTRIAL SUBSIDIES

PANEL V: IMPACT OF CHINESE INDUSTRIAL SUBSIDIES ON U.S. INDUSTRIES

CHINA'S WTO COMPLIANCE AND INDUSTRIAL SUBSIDIES

Tuesday, April 4, 2006

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room Room 2325, Rayburn House Office Building, Washington, D.C. at 9:35 a.m., Chairman Larry M. Wortzel and Commissioners Peter Brooks and Michael R. Wessel (Hearing Cochairs), presiding.

OPENING STATEMENT OF CHAIRMAN LARRY M. WORTZEL

CHAIRMAN WORTZEL: Good morning. Welcome to the U.S.-China Economic and Security Review Commission's hearing on China's WTO Compliance and Industrial Subsidies. The administration over the past several months has emphasized the importance of China taking responsible actions as a member of the international community; "a stakeholder" is the term. China's compliance with its WTO accession agreement is a major indicator of its ability and willingness to be that responsible stakeholder in the international trading system.

This hearing continues the Commission's earlier examination of China's capacity and willingness to fulfill its WTO obligations. China has made progress in implementing the measures to which it agreed when it joined the WTO.

However, I think it's fairly obvious to industry and to the commission that China has failed to protect intellectual property rights adequately. I also I think it's fair to say that China continues to maintain a system of government subsidies and preferential treatment for domestic industries.

Therefore, today we will examine the form and function of the Chinese government subsidies regime and preferential treatments for its domestic industries and the impact of these actions on the United States.

The cochairs for today's hearing are Commissioner Peter Brookes and Commissioner Michael Wessel. Thanks very much.

[The statement follows:]

Prepared statement of Chairman Larry M. Wortzel

Good morning. Welcome to the U.S.-China Economic and Security Review Commission's hearing on *China's WTO Compliance and Industrial Subsidies*. The Administration has repeated over the last several months the importance of China taking responsible actions as a member of the international community. China's compliance with its WTO accession agreement is a major indicator of its ability and willingness to be a stakeholder in the international trading system.

This hearing continues the Commission's earlier examination of China's capacity to fulfill its WTO obligations. China has made progress in implementing the measures to which it agreed in joining the WTO. However, it has failed to protect intellectual property rights (IPR) and it continues to maintain a system of government subsidies and preferential treatment for domestic industries.

Today, the Commission will focus on examining the form and function of the Chinese government's subsidies regime and preferential treatment for its domestic industries. The cochairs for today's hearing are Commissioner Peter Brookes and Commissioner Michael Wessel.

OPENING STATEMENT OF COMMISSIONER PETER BROOKES, HEARING COCHAIR

HEARING COCHAIR BROOKES: Thank you, Mr. Chairman. Good morning, everyone. I'm pleased to be here chairing my first hearing with the U.S.-China Economic and Security Review Commission, and I want to thank all of you for joining us today.

As you know, China's economic clout demands that it play a responsible role in maintaining the rules-based system of global trade. Holding Beijing responsible for its World Trade Organization obligations is a major step towards holding China responsible in all aspects of its international behavior, be it cooperation on Iran's nuclear program, active participation in the North Korean Six-Party Talks, or a contribution to constructive dialogue on meeting global energy needs.

In its 2005 Report to Congress, this Commission found that, quote:

"China remained in violation of its WTO commitments in a number of important areas. While China has made progress toward meeting some commitments, shortfalls persist in many of the most significant areas for U.S. industries. As a result, U.S. firms continue to face market access barriers in China and unfair trade practices in U.S. and third-country markets."

The topic of today's hearing is the WTO compliance of China's domestic industry subsidization. China's system of preferential treatment and subsidies include no-interest or low- interest loans, lower pricing to state-owned companies for upstream industrial products, and preferential tax policies.

In my judgment, the Commission's decision to look into this matter could not be timelier. Just last week, U.S. Trade Representative, Ambassador Rob Portman, announced his request for WTO dispute settlement consultations with China on unfair treatment through discriminatory tax policy on imports for U.S. auto parts.

In order to maintain a strong relationship with China and reap the successes of free trade and globalization, it is critical that China abide by its WTO obligations. These dispute settlement consultations are important in making that happen.

We are pleased to have with us this morning Tim Stratford, the Assistant U.S. Trade Representative for China Affairs. He will discuss China's WTO compliance and, more broadly, the U.S.-China trade relationship and the administration's strategy for that relationship.

Mr. Stratford is responsible for developing and implementing U.S. trade policy toward mainland China, Taiwan, Hong Kong, Macao and Mongolia. Prior to his appointment, Mr. Stratford served as General Counsel for General Motors' China's operations. Most recently, Mr. Stratford was largely responsible for the administration's recent Top-to-Bottom Review of U.S.-China trade relations. I applaud him for his role in that important undertaking.

In our second panel of the morning, we will hear from Loren Yager, Director of International Trade at the Government Accountability Office. Among other foreign policy issues, Dr. Yager is responsible for GAO's work analyzing U.S. trade as well as the trade remedies available to the U.S. and managing that relationship.

Prior to joining GAO, Dr. Yager was an economic analyst at the RAND Corporation where he authored studies on high-technology trade and U.S.-Japan trade policy.

Dr. Yager has also held positions as an economist with the Aerospace Industries Association and the Bureau of Labor Statistics.

I look forward to all of today's panels. Let us see if my cochair, Mr. Wessel, would like to make a statement, and then we'll move to Mr. Stratford.

[The statement follows:]

Prepared statement of Commissioner Peter Brookes, Hearing Cochair

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I look forward to both panels.

OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL, HEARING COCHAIR

HEARING CO-CHAIR WESSEL: Thank you to my cochair and to the chairman and thank you, first of all, to Mr. Stratford. I have to say that there has been a significant amount of cooperation between the USTR and this group, which we are very appreciative of, and hope that we can forge a better working relationship in the coming months.

Today's hearing addresses the important topic of China's subsidy policies and practices and their impact on U.S. farmers, workers, businesses, and our economy as a whole. The hearing comes at an important time as President Bush and Chinese President Hu prepare to meet in just a few short weeks.

As part of China's accession to the WTO, it promised to provide specific data and information on what subsidies it has in place. Five years later, we are still waiting on China to fulfill that simple obligation, to provide the required data and notification that was promised.

This hearing seeks to begin the process of defining what China's subsidy practices are in the absence of their compliance with their notification commitments. Witnesses will help us understand what the legal framework is regarding Chinese subsidies.

We also hope to understand how best to gain the necessary data and information to respond to those subsidies that are altering the terms of trade.

There can be no doubt that China is engaged in massive efforts to subsidize the development of its economy and to promote the further growth of its export base. Indications are that China is subsidizing the development of new industries, nanotechnology, biotechnology and opt-electronics. It's focused not just on developing current industrial capacity but in being the leader of tomorrow's industries as well.

A majority of China's exports come from foreign-invested enterprises. Rather than fulfilling the predictions and promises of those supporting China's entry into the WTO, that it would result in dramatic new access to the Chinese market, we find that much of the investments going into China are to fuel their export-led growth.

In many cases, the investments are used to promote "industrial tourism," the shipment of component parts to China, only to be assembled into products that are shipped right back out.

Anecdotes as to tax subsidies, land subsidies, two-tiered pricing of energy and many other subsidies for companies to locate their production in China abound.

Industry after industry receive these benefits--steel, auto, semiconductors, to name just a few. Add to these direct subsidies the subsidy value of currency manipulation, workers rights violations, intellectual property rights violations, non-performing loans, and many other practices, and you find an almost unbeatable combination of tools and incentives that are used to alter the terms of trade.

The result is, in part, huge and increasing bilateral trade deficits with United States and the migration of production in jobs to China.

Today's hearing will begin to help us understand the scope of the problem and what can be done about it. Like all problems with China, dealing with these subsidies won't be easy. The lack of transparency is a huge barrier to action. But we can't afford much longer to ignore the unfair and unacceptable subsidies that China broadly offers to promote its own economic interests.

Thank you.

[The statement follows:]

Prepared statement of Commissioner Michael R. Wessel
Hearing Cochair

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PANEL I: ADMINISTRATION PERSPECTIVES ON CHINA'S WTO COMPLIANCE AND USE OF SUBSIDIES

HEARING COCHAIR BROOKES: Thank you. Mr. Stratford, if you would join us. Please summarize your statement in seven to ten minutes. We have your statement for the record, so if you could that, it would give us the maximum amount of time for questions and answers.

STATEMENT OF TIMOTHY STRATFORD ASSISTANT U.S. TRADE REPRESENTATIVE

MR. STRATFORD: Thank you very much. I appreciate the opportunity to testify today on the administration's assessment of China's compliance with its obligations to the World Trade Organization.

This is a subject of considerable importance and a matter of great priority to the administration and to the Office of the United States

Trade Representative, in particular, in our capacity as the lead agency with trade policy.

I've just returned from nearly two weeks in China. Together with colleagues from the Department of Commerce, we've been engaging our Chinese counterparts in preparation for the next meeting of the Joint Commission on Commerce and Trade scheduled to take place in Washington on April 11. A number of the issues we've been discussing relate to China's WTO compliance including in the area of subsidies.

As you know, at Ambassador Portman's direction, USTR recently led an interagency "Top-to-Bottom" review of U.S. trade policy with China. When Ambassador Portman took over as the United States Trade Representative, he felt strongly that it was time to revisit how the United States approached its trade relationship with China.

Having completed the review, our view is that U.S.-China trade relations are entering a new phase in which greater accountability on China's part and greater enforcement on the administration's part are needed. We enter this new phase firm in our belief that while our bilateral trade relationship has been largely beneficial for the United States and China, it is not sufficiently balanced in the opportunities it provides.

As a result, though our overall goals and objectives remain the same, some recalibration in the way we respond to problems is required. We have a complicated task as we seek to achieve the dual objectives of solving specific immediate problems--resorting to more muscular enforcement mechanisms where necessary--and at the same time encouraging the long-term transformation of China into a more rules-based open economy.

We believe that the key to achieving those objectives is treating China as a fully accountable stakeholder in the international trading system and insisting that China play a constructive role commensurate with its commercial heft and the enormous benefits that it has gained from its participation in the global trading system.

After four years of WTO membership, China has a track record as a WTO member, and that track record is decidedly mixed. The commitments that were easiest to fulfill have largely been fulfilled, and those still outstanding will require a more serious level of bilateral and multilateral focus and attention.

In USTR's annual Report to Congress on China's WTO Compliance issued in December 2005, we provided a detailed assessment of China's first four years of WTO membership. We concluded that China has not yet fully embraced the key WTO principles of market access, non-discrimination and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent.

While China has made some important progress in implementing specific commitments from its accession agreement, we found that it continued to use an array of industrial policy tools in 2005 to promote or to protect favored sectors and industries, and these tools at times collide with China's ongoing WTO obligations.

We also catalogued specific WTO compliance problems that we are encountering, while highlighting certain areas that continue to generate the most significant problems, including inadequate enforcement of laws, particularly in the area of intellectual property rights, and problems associated with industrial policies, restrictions on market access for services, non-tariff barriers affecting trade and agriculture, and an overall lack of transparency in the regulatory environment.

For the purposes of time, I'll skip over a discussion of most of these areas and turn to say a few words specifically on subsidies.

Article 25.1 of the WTO Agreement on Subsidies and Countervailing Measures requires each WTO member to submit an annual notification of all of the subsidies that it maintains. This requirement is especially important for members like China, whose lack of transparency makes independent investigation and assessment very difficult.

China has not yet submitted a single subsidies notification since joining the WTO in December 2001. Last July, at the JCCT meeting held in Beijing, China committed to submit a detailed notification of its subsidies to the WTO by the end of 2005.

China made similar promises in formal meetings before the WTO's Council for Trade in Goods and Committee on Subsidies and Countervailing Measures last year.

However, China still has not submitted this important and long overdue notification. To the extent that we're able to develop information on particular subsidies, we've been raising them at the WTO. For example, in October 2004, the United States submitted questions about a number of subsidy programs including potentially prohibited subsidies in a WTO filing under Article 25.8 of the Subsidies Agreement, although to date China has not responded to any of those questions.

We have also regularly used the China Transitional Review Mechanism meetings at the WTO to express our concerns and seek further information. But clearly more needs to be done.

During the run-up to the April 11 JCCT meeting, the administration has continued to press China to submit its notification and has made clear to China that government subsidization in China remains a key concern for many U.S. industries.

Indeed, we've heard from a range of industries such as the steel and paper industries about the problems that Chinese government subsidization creates for them.

China's lack of transparency presents enormous challenges in trying to develop comprehensive information about the various types of financial support that China provides to its domestic industries.

We've also sought to address subsidies in other bilateral meetings. We recently began a Steel Dialogue with China, and in that context we anticipate addressing the role of the Chinese government including its provision of financial support in the restructuring of China's domestic steel industry.

We've also discussed subsidies issues more generally in connection with the JCCT Structural Issues Working Group and hope to intensify those discussions once China submits its subsidies notification in the WTO.

On April 19 and 21, the WTO members in Geneva will conduct the first Trade Policy Review of China. WTO rules require that the four members with the largest share of world trade be reviewed every two years with less frequent reviews of other members. The WTO Secretariat prepared a nearly 300 page report on China's trade policy regime, noting many of China's reforms and multitude of challenges that it still faces.

The United States has submitted more than 200 questions in connection with China's TPR including many addressing China's subsidies practices. In accordance with WTO rules, we look forward to receiving written responses from China. This TPR provides an important opportunity for the United States and other WTO members to seek an accounting from China with respect to trade practices of concern to us.

China participated actively in the TPR conducted of the United States just last month, and we're looking forward to engaging with China during this review.

The report on our "Top-to-Bottom" review of the U.S.-China trade relationship recognizes the many ongoing challenges and opportunities presented by China's emergence as a major international player. Because of the nature of the challenges, including the challenges presented by subsidies, and because it's time to insist that China be held accountable as would any mature partner and responsible stakeholder in an international trading system, the report recommends that U.S. trade resources and priorities be readjusted in a number of ways.

First and foremost, the report calls for strengthening the United States' current focus on China's WTO compliance and adherence to international norms. The report also urges that more focus be put on ensuring that the bilateral trade relationship offers more balanced opportunities and is more equitable and durable.

The report also cites a need for U.S. trade policymaking to be more proactive and informed by more comprehensive information regarding China's economic trends and developments, with stronger coordination within the executive branch and between the executive and congressional branches.

The report further highlights the need for China to participate more fully in the global trading system and for the United States to remain an active and influential economic and trading power in the Asia Pacific region generally.

In the report, USTR lays out a series of actions that will help ensure that the United States is positioned to achieve these objectives.

First, USTR will seek to enhance its trade enforcement capacity along with its capacity to obtain and process comprehensive forward-looking information about the U.S.-China trade relationship.

We will also seek to expand our trade resources in Beijing and strengthen interagency coordination. In addition, we seek to strengthen, expand and increase the effectiveness of the U.S.-China dialogue on China's needed structural economic reforms and on numerous specific issues such as standards, SPS, China subsidies, financial services, telecommunication services, labor, environmental protection and transparency and the rule of law, among other issues.

The administration recognizes as well the importance of increasing coordination with other trading partners in pursuing these issues and, as evidenced by its coordination with European and Asian partners on IPR and auto parts issues, is already vigorously pursuing such coordination.

In conclusion, I'd like to say just a few words specifically on enforcement. The administration will not hesitate, when appropriate, to use all tools at its disposal to ensure that China lives up to its commitments including dispute resolution at the WTO or the use of trade remedies within our own legal system. In January of this year, we were poised to bring a case against China for its treatment of our Kraft Linerboard exports, when at the 11th hour China reversed course and rescinded its improper antidumping duties.

We will continue to hold China accountable. That is our responsibility to the workers, farmers, and businesses here in the United States. We have emphasized to China that utilizing these tools should not be viewed as a failure in our bilateral trade relationship. If our two countries have a dispute and use legal channels to resolve it, it's not a sign of an adversarial relationship, but rather a sign of a mature one.

Disputes between the United States and Europe, for example, have not obscured the benefits of our billion-dollar-a-day trade relationship. Rather, knowing that litigation is a real option tends to have the benefit of focusing minds on viable solutions.

To give some perspective on this issue, the European Community has been sued 63 times and the United States 86 times since the WTO entered into force in 1995. Interestingly, the United States and the EC have tracked each other closely over the years in terms of the number of cases with the number declining for both in recent years.

Since 2001, the U.S. and EU have each brought exactly 16 cases. Other WTO members have been very active as well. For example, Brazil has brought 22 WTO cases, 16 of them since 2000. In that same period, Korea has brought ten WTO cases. But in many ways, China has been an anomaly in terms of its isolation from the WTO dispute settlement process.

Despite its growing economic presence, China has been the defendant in exactly one WTO case brought by the United States. And now a second case.

Now that China's transition period as a new WTO member is drawing to an end, we should expect China to be more active in the dispute settlement mechanism, both as a complainant and as a defendant.

Mr. Chairman and members of the Commission, thank you for providing me with the opportunity to testify. I look forward to your questions.

[The statement follows:]

Prepared statement of Timothy Stratford, Assistant U.S. Trade Representative

China's WTO Compliance and Industrial Subsidies

Introduction

Chairman Wortzel and members of the Commission, I appreciate the opportunity to testify today on the Administration's assessment of China's compliance with its obligations to the World Trade Organization (WTO). This is a subject of considerable importance and a matter of great priority to the Administration, and to the Office of the United States Trade Representative (USTR) in particular, in our capacity as the lead agency with responsibility for trade policy.

I have just returned from nearly two weeks in China. Together with colleagues from the Department of Commerce, we have been engaging our Chinese counterparts in preparation for the next meeting of the Joint Commission on Commerce and Trade (JCCT), scheduled to take place in Washington on April 11. A number of the issues we have been discussing relate to China's WTO compliance, including in the area of subsidies.

As you know, at Ambassador Portman's direction, USTR recently led an interagency "top-to-bottom" review of U.S. trade policy with China. When Ambassador Portman took over as the United States Trade Representative, he felt strongly that it was time to revisit how the United States approached its trade relationship with China. Having completed the review, our view is that U.S.-China trade relations are entering a new phase in which greater accountability on China's part and greater enforcement on the Administration's part are needed.

We enter this new phase firm in our belief that, while our bilateral trade relationship has been largely beneficial for both the United States and China, it is not sufficiently balanced in the opportunities it provides. As a result, though our overall goals and objectives remain the same, some recalibration in the way we respond to problems is required. We have a complicated task as we seek to achieve the dual objectives of solving specific, immediate problems – resorting to more muscular enforcement mechanisms where necessary – and encouraging the long-term transformation of China into a more rules-based, open economy. We believe that the key to achieving those objectives is treating China as a fully accountable stakeholder in the international trading system and insisting that China play a constructive role commensurate with its commercial heft and the enormous benefits that it has gained from its participation in the global trading system.

A New Phase in U.S.-China Trade Relations

Thirty years ago, China was a nation mostly closed to international commerce. Today, it is the world's third largest trading power. China's emergence over this period as a major international player has not only redefined the global trading system, but also has had far-reaching economic and political impact on China, the United States, East Asia and the world.

The trade relationship between the United States and China has become increasingly central to the economies of both our countries. China's economy has been growing at roughly 10 percent per year for more than two decades, and its growth has been closely tied to the open trade and investment regimes of the major economies of the world. Exports account for 40 percent of China's GDP, and China has depended on the growth of its export sector to spur modernization of its economy and to support improved standards of living. According to Chinese data, the United States market has been the direct recipient of 22 percent of China's phenomenal export growth over the last twenty years. The United States has also derived benefits from the trade relationship. U.S. consumers now have access to a wider variety of less costly goods, and low-cost consumer and industrial goods from China have helped spur U.S. economic growth while keeping a check on inflation. Access to Chinese inputs has helped make U.S. companies more competitive in the global economy. Since 2001, when China joined the World Trade Organization (WTO), U.S. exports to China have grown five times faster than they have to the rest of the world, and China has gone from being the ninth to the fourth biggest export market for the United States. U.S. exports to China increased by an impressive 21 percent in 2005, building on 22 percent growth in 2004 and making China our fastest growing export market among our major trading partners. Together, the United States and China have accounted for roughly half of the economic growth globally in the past four years. Market forces continue to drive broader and deeper economic ties between our two countries.

At the same time, the enormous scope and scale of the changes that have occurred in China's trading posture and in our bilateral trade relationship pose continual challenges. As China's economy and our bilateral trade have grown, our trade relationship has become enormously complex. Features of this relationship – the size of China's consumer base and labor force, for example, or the increasing sophistication of Chinese production – can be both encouraging and a cause for concern at the same time. The relationship lends itself neither to simplistic characterizations nor to simple policy prescriptions.

Overall, despite many positive developments, there is concern that the U.S.-China trade relationship lacks balance in opportunity, as well as equity and durability, with China's focus on export growth and developing domestic industries not being matched by a comparable focus on fulfilling market opening commitments or on the protection of intellectual property rights (IPR) and internationally recognized labor rights.

In our "top-to-bottom" review, the Administration examined the United States' trade relationship with China over the years and concluded that the United States is now entering an important new phase in its relationship with China. We view it as the third phase in that relationship.

The first phase began in 1986 when the United States formally acknowledged China's goals to modernize and integrate itself into the global marketplace by commencing negotiations for China to become a party to the General Agreement on Tariffs and Trade (GATT), or as it was subsequently renamed, the World Trade Organization. That phase lasted for 15 years and was focused on identifying and negotiating the kinds of commitments China needed to make in order to gain admission to the WTO. Great strides were made during that first phase in modernizing and strengthening our bilateral trade relationship. By the end of this period, China had made enough progress in its own program for reform and opening that it was able to agree to lower trade barriers in virtually every sector, protect intellectual property rights, and adopt special rules to address subsidies and other forms of state ownership and control of economic resources.

The second phase began in December 2001, when China joined the WTO. While its accession agreement called on China to implement a large number of commitments immediately as a condition of membership, China was also allowed to implement many other, often significant commitments over a period of years – including not only scheduled reductions in tariff rates, but also the elimination of numerous non-tariff barriers and expansions in market access for a variety of service sectors. During this transition period, U.S. trade policy towards China was largely focused on ensuring that China implemented these specific commitments, and our view of China's performance as a trading partner was largely based on how fully and timely it implemented them. Spurred on by our vigilance and engagement, China made progress in implementing many of its commitments. For example, China lowered its tariffs on the goods of greatest value to the U.S. economy from an average of 25 percent to an average of 7 percent, while removing or reducing numerous non-tariff barriers such as quotas and licensing requirements. China also followed through on its important commitments to make trading rights available to foreign enterprises and individuals, and to allow foreign suppliers to engage in distribution within China. In addition, China created new opportunities for many foreign companies in a range of service sectors.

It has now been more than four years since China joined the WTO, and as our "top-to-bottom" review report concluded, we are entering a new – third – phase in the U.S.-China trade relationship. China's transition period as a new participant in the international trading system – and, in particular, the WTO – has now come to a close, and China is expected to act and will be treated as a fully accountable participant in and beneficiary of the international trading system. Like any stakeholder, China must find a way to pursue its own self-interest while also adhering to, and helping to shape, the policies and institutions that undergird its own growing prosperity and the prosperity of its trading partners.

Challenges in the Relationship

After four years of WTO membership, China has a track record as a WTO member, and that track record is decidedly mixed. The commitments that were easiest to fulfill have largely been fulfilled, and those still outstanding will require a more serious level of bilateral and multilateral focus and attention.

In USTR's annual Report to Congress on China's WTO Compliance issued in December 2005, we provided a detailed assessment of China's first four years of WTO membership. We concluded that China has not yet fully embraced the key WTO principles of market access, non-discrimination and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent. While China has made some important progress in implementing specific commitments from its accession agreement, we found that it continued to use an array of industrial policy tools in 2005 to promote or protect favored sectors and industries, and these tools at times collide with China's ongoing WTO obligations. We also catalogued specific WTO compliance problems that we are encountering, while highlighting certain areas that continue to generate the most significant problems, including inadequate enforcement of laws, particularly in the area of intellectual property rights, and problems associated with industrial policies, restrictions on market access for services, non-tariff barriers affecting trade in agriculture, and an overall lack of transparency in the regulatory environment.

On April 19 and 21, WTO Members will meet in Geneva to conduct the first Trade Policy Review (TPR) of China. WTO rules require that the four Members with the largest share of world trade be reviewed every two years, with less frequent reviews of other Members. The WTO Secretariat prepared a nearly 300-page report on China's trade policy regime, noting China's many reforms and the multitude of challenges that it still faces. The report projects that China will need to create over 100 million jobs in the next decade as it continues to restructure its economy, especially its agriculture sector and state-owned enterprises. This will present major challenges for China, and could have a significant impact on other Members. The Report also notes the need for policy realignments to prevent misallocation of resources and overinvestment in certain sectors. The United States has submitted more than 200 questions in connection with China's TPR, including many addressing China's subsidies practices. In accordance with WTO rules, we look forward to receiving written responses from China. This TPR provides an important opportunity for the United States and other WTO members to seek an accounting from China with respect to trade practices of concern to us. China participated actively in the TPR conducted of the United States just last month, and we are looking forward to engaging with China during its review.

Among the many challenges we are facing in our bilateral trade relationship with China, the area of intellectual property rights is especially significant. While China has made noticeable improvements to its framework of laws and regulations, the general lack of effective IPR enforcement remains an enormous challenge. At the JCCT in 2004, China committed to significantly reduce counterfeiting and piracy. Nearly two years have gone by and the results demonstrate isolated − but not significant − progress. For example, U.S. trademark owners have met with some promising early successes in a campaign to impose liability on the landlords of markets that are notorious for selling fakes, such as the Silk Market in Beijing.

At the same time, there are troubling signs. In 2005, for instance, the share of IPR infringing goods seized by U.S. Customs originating in China increased to 69 percent from 64 percent in 2004, despite China's declaration at the 2005 JCCT that exportation is a criminal offense. Moreover, China has not yet met its 2005 JCCT commitment to issue regulations on transferring IPR cases from customs officials to criminal prosecutors. This may help to explain why we have not seen prosecutions of exporters of counterfeit and pirated goods.

In other IPR areas, we have also not seen significant progress. For example, while the use of pirated software on Chinese government computers has declined since China's 2004 and 2005 JCCT commitments to ban illegal software in government offices, we have not seen clear evidence that the problem has been fully resolved. There is also widespread software piracy outside the government in China, which China has begun to take steps to confront. We would like to continue working with China to achieve success in these areas. Similarly, given the widespread availability of pirated movie DVDs and music CDs in stores and on streets across China, we have urged China to remedy this problem once and for all through permanent plant closures, criminal prosecutions and on-going monitoring and enforcement. China agreed to step up criminal enforcement, but we have seen only a very small increase in the number of criminal copyright cases. We stand ready to cooperate toward this end. The Internet is another means that has also been used extensively in China and elsewhere for IPR-infringing purposes. China agreed at the JCCT last year to submit the legislative package necessary to join the WIPO Internet Treaties to its National People's Congress in June of this year. We have worked with and will continue working with China on the details of this very important package.

Last year, USTR concluded an out-of-cycle review under the Special 301 provisions of U.S. trade law, and elevated China to the Special 301 "Priority Watch" list. We set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, including the possible use of WTO mechanisms, as appropriate. In October 2005, the United States submitted a transparency request to China under Article 63.3 of the WTO Agreement on Trade-Related Aspects of Intellectual Property rights. The U.S. request, made in conjunction with similar requests by Japan and Switzerland, sought detailed information from China on its IPR enforcement efforts over the last four years. China has provided the United States with some information, but not a complete response. We will release our Special 301 Report this year according to the deadlines Congress has established.

We have also seen China increasingly resort to industrial policies that limit market access by non-Chinese origin goods or services or rely on government resources to support increased exports. The objectives of these policies are to protect less-competitive domestic industries and support the development of Chinese industries higher up the economic value chain than those industries that currently make up China's labor-intensive base. In 2005, examples of these industrial policies were readily evident. They included the issuance of regulations on auto parts tariffs that discourage the use of imported parts, the telecommunications regulator's interference in commercial negotiations over licenses with IPR holders in the area of 3G standards, the pursuit of unique national standards in a number of high technology areas that could lead to the extraction of technology or intellectual property from foreign rights-holders, draft government procurement regulations mandating purchases of Chinese-produced software, a new steel industrial policy that calls for the state's management of nearly every major aspect of China's steel industry, continuing export restrictions on coke, removal of provisions addressing government monopolies from the current draft of the anti-monopoly law, and excessive government subsidization benefiting a range of domestic industries in China (as discussed more fully below). We believe that such policies not only harm U.S. and third-country competitors, they redound to China's detriment as well. Moreover, some of these policies appear to conflict with China's WTO commitments. We are taking a hard look at them and will not hesitate to take action at the WTO if such action appears warranted.

In the area of services, concerns in many sectors remain, largely due to arbitrary and non-transparent policies, delays in the issuance of regulatory measures, and China's use of entry threshold requirements that exceed international norms. Indeed, Chinese regulatory authorities continue to pose obstacles to the efforts of U.S. providers of distribution, express delivery, direct selling, franchising, insurance, construction and engineering, telecommunications and other services to achieve their full market potential in China.

Agriculture is a high priority of the Administration's trade relations with China. While China is one of our farm sector's best customers, the record demonstrates that China does not always base its food safety decisions on science, as evidenced by its continued ban on U.S. beef. Last year, the United States and China initialed a Memorandum of Understanding to facilitate cooperation on animal and plant health safety issues. However, agricultural trade with China remains among the least transparent and predictable of the world's major markets. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities.

Transparency concerns cut across sectors, as China's various regulatory regimes continue to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. Although China has taken steps to improve transparency across a wide range of national and provincial regulatory authorities, particularly at the Ministry of Commerce, many other ministries and agencies have made less than impressive efforts to improve their transparency. U.S., Chinese and other participants in commercial activities across China would benefit greatly if China fully adhered to its WTO commitment to maintain an official journal dedicated to the publication of all trade-related measures, and provided ample opportunity for prior public comment before such measures became effective.

Overall, while China has a more open and competitive economy than 25 years ago, and China's WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled. If China is to complete the implementation of its WTO commitments and institutionalize market-oriented reforms, it will need to eliminate mechanisms that allow government officials to intervene in the Chinese economy in a manner that is inconsistent with market principles. Despite its remarkable transformation over the past quarter century, China continues to suffer from its command economy legacy. As a result, Chinese economic policy-making often operates in a way that prevents U.S. businesses from achieving their full potential in the China market. As U.S. expectations shift from the establishment of basic regulations and implementation of specific WTO commitments to measurable improvements in market access for U.S. products and services, there will be decreasing tolerance for Chinese efforts to protect domestic industries. JCCT meetings have provided bilateral opportunities to discuss and find solutions for many issues of particular importance in U.S.-China trade relations. We value the open, productive, problem-solving approach China has taken at the 2004 and 2005 JCCT meetings, and hope that the JCCT will continue to function as a meaningful forum for the resolution of trade frictions.

Subsidies

Article 25.1 of the WTO Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) requires each WTO member to submit an annual notification of all of the subsidies that it maintains. This requirement is especially important for members like China, whose lack of transparency makes independent investigation and assessment very difficult.

China has not yet submitted a single subsidies notification since joining the WTO in December 2001. Last July, at the JCCT meeting held in Beijing, China committed to submit a detailed notification of its subsidies to the WTO by the end of 2005. China made similar promises in formal meetings before the WTO's Council for Trade in Goods and Committee on Subsides and Countervailing Measures (Subsidies Committee) last year. However, China still has not submitted this important − and long overdue − notification.

During the run-up to the April 11 JCCT meeting, the Administration has continued to press China to submit its notification and has made clear to China that government subsidization in China remains a key concern for many U.S. industries. Indeed, we have heard from a range of industries, including some that will testify today, such as the steel and paper industries, about the problems that Chinese government subsidization creates for them. As these industries will also tell you, China's lack of transparency presents enormous challenges in trying to develop comprehensive information about the various types of financial support that China provides to its domestic industries.

To the extent that we are able to develop information on particular subsidies, we have been raising them at the WTO. For example, in October 2004, the United States submitted questions about a number of subsidy programs, including potentially prohibited subsidies, in a WTO filing under Article 25.8 of the Subsidies Agreement, although to date China has not responded to any of those questions. We have also regularly used the China Transitional Review Mechanism (TRM) meetings at the WTO to express our concerns and seek further information.

We have also sought to address subsidies issues in bilateral meetings with China. We recently began a Steel Dialogue with China, and in that context we anticipate addressing the role of the Chinese government, including its provision of financial support, in the restructuring of China's domestic steel industry. We have also discussed subsidies issues more generally in connection with the JCCT Structural Issues Working Group and hope to intensify those discussions once China submits its subsidies notification to the WTO.

Readjusting U.S. Trade Resources and Priorities

The report on our "top-to-bottom" review of the U.S.-China trade relationship recognizes the many ongoing challenges, and opportunities, presented by China's emergence as a major international player. Because of the nature of the challenges, and because it is time to insist that China be held accountable as would any mature partner and responsible stakeholder in the international trading system, the report recommends that U.S. trade resources and priorities be readjusted in a number of ways.

First and foremost, the report calls for strengthening the United States' current focus on China's WTO compliance and adherence to international norms. The report also urges that more focus be put on ensuring that the bilateral trade relationship offers more balanced opportunities and is equitable and durable. The report also cites a need for U.S. trade policymaking to be more proactive and informed by more comprehensive information regarding China's economic trends and developments, with stronger coordination within the Executive branch and between the Executive and Congressional branches. The report further highlights the need for China to participate more fully in the global trading system as a responsible trading partner, and for the United States to remain an active and influential economic and trading power in the Asia Pacific region.

The report goes on to identify six key China trade objectives as we move forward. They include: (1) integrating China more fully as a responsible stakeholder into the global rules-based system of international trade and secure its support for efforts to further open world markets; (2) monitoring China's adherence to international and bilateral trade obligations and secure full implementation and compliance; (3) ensuring that U.S. trade remedy and other import laws are enforced fully and transparently, so that Chinese imports are fairly traded, and U.S. and Chinese products are able to compete in the U.S. market on a level playing field; (4) securing further access to the Chinese market and greater economic reforms in China, beyond what is granted under China's current commitments, to ensure that U.S. companies and workers can compete on a level playing field; (5) pursuing effective U.S. export promotion efforts with special attention to areas of particular U.S. export growth potential in China; and (6) identifying mid- and long-term challenges that the trade relationship may encounter, and seeking proactively to address those challenges.

In the report, USTR lays out a series of actions that will help ensure that the United States is positioned to achieve these objectives. First, USTR will seek to enhance its trade enforcement capacity, along with its capability to obtain and process comprehensive, forward-looking information about the U.S.-China trade relationship. We will also seek to expand our trade resources in Beijing and strengthen interagency coordination and the Executive-Congressional partnership on China trade. In addition, we seek to strengthen, expand and increase the effectiveness of the U.S.-China dialogue on China's needed structural economic reforms and numerous specific issues, such as standards and SPS issues, China's subsidies practices, financial services, telecommunications services, labor, environmental protection, and transparency and the rule of law, among other issues. The Administration recognizes as well the importance of increasing coordination with other trading partners in pursuing these issues and – as evidenced by its coordination with European and Asian partners on IPR and auto parts issues – is already vigorously pursuing such coordination.

Engaging China

Bilateral Engagement

Through sustained and constructive engagement, the United States has contributed greatly to China's integration into the global economy – to the benefit of both countries. Indeed, more has been done by the United States to promote and facilitate China's integration into the international trading system than has been done by any other nation in the world, and the United States will continue to engage China as it continues its transformation. We continue to believe that U.S. interests are best pursued through further opening of the Chinese market, not by closure of U.S. markets.

To ensure that the economic benefits of the U.S.-China trade relationship are protected, and the potential gains are achieved, we must demonstrate that we can cooperate effectively to resolve bilateral issues. Such cooperation was evidenced last year, when the United States and China reached an agreement on textiles, adding much-needed predictability to bilateral trade, to the benefit of producers and consumers. We will continue to seek to work constructively with China, to resolve bilateral challenges and to develop a U.S.-China relationship that has greater equity, durability, and balance of opportunities.

Regional Engagement

Looking beyond the bilateral issues, China can also take actions that demonstrate it is prepared to play a role as a responsible stakeholder in the international economic system commensurate with its commercial heft and with the benefit it has obtained from that system. China should work closely with its partners in regional fora, such as APEC. China needs to play a constructive role in ensuring that the conditions for safe, secure and efficient trade prevail in the region. As both a driver and beneficiary of economic growth in the Asia Pacific region, China has a great incentive in joining with other regional economies to open markets, promote trade security, and build the infrastructure needed to ensure that trade can flow smoothly. It also has powerful incentives to address proactively threats – such as disease and pollution – that do not recognize national borders, but that could have enormously damaging effects on trade – to say nothing of human welfare – if left unaddressed.

It bears mentioning that the United States is also actively seeking to broaden its trade relations with countries in the region. Whether through free trade agreements (concluded with Singapore and being pursued with Korea, Malaysia, and Thailand), bilateral WTO accession agreements (Vietnam, Cambodia and Laos), or other trade-enhancing arrangements, USTR is working actively to strengthen and deepen U.S. trade relations in East Asia. These efforts will ensure that we maintain durable and balanced ties in the region as a whole, to the benefit of those countries and the United States.

Multilateral Engagement

Multilaterally, China can strengthen the WTO by opening its markets beyond the specific requirements of its accession agreements, and by playing a more active and positive role in the Doha Round negotiations, which are at a critical juncture. China has gained a lot from its membership and participation in the international trading system, and it stands to lose much if that system is weakened or atrophies. As it takes its place as one of the larger WTO members, China should be expected to provide leadership in advancing the rules-based system and a global framework for fair and free trade in the context of the WTO. At the most basic level, that means advancing meaningful offers and requests in the WTO negotiations, especially in the areas of agriculture and services. It also means fully embracing and complying with the letter and spirit of the obligations it has already undertaken.

Enforcement

The Administration will not hesitate, when appropriate, to use all tools at its disposal to ensure that China lives up to its commitments, including dispute settlement at the WTO or the use of trade remedies within our own legal system. In January of this year, we were poised to bring a case against China for its treatment of our kraft linerboard exports, when at the eleventh hour China reversed course and rescinded its improper antidumping duties. We will continue to hold China accountable. That is our responsibility to the workers, farmers and businesses here in the United States.

Utilizing these tools should not be viewed as a failure in our bilateral relationship. If our two countries have a dispute and use legal channels to resolve it, it is not a sign of an adversarial relationship but rather a sign of a mature one. Disputes between the United States and Europe, for example, have not obscured the benefits of our billion-dollar-a-day trade relationship. Rather, knowing that litigation is a real option tends to have the benefit of focusing minds on viable solutions. To give some perspective on this issue, the European Communities (EC) has been sued 63 times and the United States 86 times since the WTO entered into force in 1995. Interestingly, the United States and the EC have tracked each other closely over the years in terms of the number of cases, with the number declining for both in recent years. Since 2001, the U.S. and EU have each brought exactly 16 cases. Other WTO members have been very active as well. For example, Brazil has brought 22 WTO cases, 16 of them since 2000. In that same period, Korea has brought 10 WTO cases.

In many ways, China has been an anomaly in terms of its isolation from the WTO dispute settlement process. Despite its growing economic presence, China has been the defendant in exactly one WTO case, brought by the United States. Now that China's transition period as a new WTO member is drawing to an end, we should expect China to be more active in the dispute settlement mechanism, both as a complainant and a defendant.

We have recently announced the establishment of a China Enforcement Task Force at USTR, as promised in our "top-to-bottom" review of the U.S.-China trade relationship. The task force has already met and begun its work, and it has moving forward quickly with a broad and aggressive agenda. The task force has begun focusing on issues where there is a need to enforce China's WTO obligations through dispute settlement. But, it will also approach enforcement in a more comprehensive manner, by using WTO mechanisms short of dispute settlement more effectively, by seeking to ensure that China lives up to the bilateral commitments that it has made, for example, in the JCCT context, and by developing strategies for addressing trade problems that have so far not lent themselves to effective discipline, such as the Chinese government's excessive subsidization of a range of Chinese industries.

Conclusion

Mr. Chairman and members of the Commission, thank you for providing me with the opportunity to testify. I look forward to your questions.

Panel I: Discussion, Questions and Answers

HEARING COCHAIR BROOKES: Thank you very much, Mr. Stratford, for your testimony today. I have a number of commissioners who want to ask questions. We'll go ahead and start with Chairman Wortzel, and then Mr. Wessel and myself, and I have Mr. D'Amato and Mr. Blumenthal also and Mr. Mulloy.

CHAIRMAN WORTZEL: Tim, thanks for being here and for your great service to the nation. For those of you who do not know it, Mr. Stratford and I served in Beijing together twice at the Embassy. He does great things. I was very pleased to see you back in government in the position you're in now.

Your written testimony discusses industrial policies that limit market access or rely on government resources to support increased exports. Those are subsidies.

So when China makes the submission to which you referred to the WTO, can you describe how USTR will validate that it is actually true? Do you have plans to carve out in a specific industrial area for a case study, for an in-depth look, a full review? Is there an industrial area where China's policies have a more drastic effect on the United States than others, and if so how are you going to approach that?

MR. STRATFORD: The first thing we have to do is get their notification of subsidies, of course. We do expect to receive that soon. We were told before Christmas that they actually had the report done and were working on the translation. We still haven't seen it, however. I think we're ready to offer to help with the translation if necessary, but I think it may be a very long report.

When we receive the report, the first thing we'll do is look at the types of subsidies that are included. As you may know, there are some sorts of subsidies that cause more WTO concerns than other types of subsidies.

Under the WTO, there are prohibited subsidies, specifically subsidies that support import substitution or that support exports, and these are the subsidies where it's easier to win a case in the WTO, for example. You don't have to show injury to your own industry.

One of the things we'll do is we'll be looking to see where there may be prohibited subsidies and focus first on those because that's the low-hanging fruit in terms of addressing problems.

Of course, we'll also be looking at the list to see if there are subsidies that we're aware of from various sources that are not included on the list, and we will certainly follow up with China on those.

We will also be reaching out to the industries that are affected by the subsidies and seek input from industry as to where they have the most concerns.

As I've mentioned, the steel industry, the paper industry are two industries in particular that have come forward to us and expressed concerns about how Chinese practices are affecting them and this is certainly an example where we will need and we will seek and we will value the input that we get from the industries so that we can prioritize where we should devote our resources first in order to have the most impact.

HEARING COCHAIR BROOKES: Thank you.

President Hu Jintao is coming to the United States. What do you expect to achieve through this high level summit in terms of trade and the issues that you've outlined this morning in the U.S.-China trade relationship?

MR. STRATFORD: Obviously, we're involved in detailed discussions with the Chinese government right now, not only in connection with President Hu's visit, but also in connection with the April 11 visit of Vice Premier Wu Yi.

In a lot of ways, we're not focusing on whether it's an issue for the Vice Premier or an issue for the President. We have a set of priority issues and we're discussing them with the Chinese government.

These discussions are not easy. To the extent that we have a strong case, then we can make some progress. To the extent that the issues may not be clear-cut WTO violations or to the extent that they may cut against the grain of current trends in China, it's not easy to make progress in a lot of these discussions.

That said, we have tried to identify again what we see as some of the low-hanging fruit in terms of issues where we think that the Chinese government would have the capability to address some of our issues.

I would rather not go into detail in some of the specifics of the negotiations because these negotiations are going on even as we speak here today, but I hope that we'll be able to make some positive announcements next week during the Vice Premier's visit and further during President Hu's visit.

HEARING COCHAIR BROOKES: Thank you. Commissioner Wessel.

HEARING COCHAIR WESSEL: Thank you. I'd like to understand a little more about the overall evaluation of these subsidies, understanding that we're still waiting on China's notifications.

China recently put into effect its 11th Five Year Plan, which seems to be a road map in some ways for those subsidies. If you look through it--advanced computing, biomedical activities, high tech, civil airplane--you can go down a list within the context of their Five Year Plan.

In the absence of their notifications, how is the USTR looking at this Five Year Plan? Can we use that as a road map of their subsidy policies so that we can begin to address and ask China to back off those that are WTO illegal?

MR. STRATFORD: I think that looking at the plan is helpful because it gives you some general ideas of where to look, but the plan tends not to be specific enough in describing the support the government is going to give in order to give you a basis for a clear-cut action. But it certainly does guide you in some of the questions that you ought to be asking in the areas where you ought to be probing further.

We're certainly looking at that, and one example I'll give is in the steel industry. As I mentioned, we had the first meeting of the Steel Dialogue last week. On the U.S. side, the Steel Dialogue is chaired by me, as a representative from USTR, and by Jamie Estrada at the Department of Commerce. Jamie wasn't able to be there but Frank Lavin from Commerce was there.

This was an introductory meeting. We met with a Deputy Director General from the Ministry of Commerce who's responsible for import regulation but who also looks at a lot of the trade issues.

For example, he's the person that we had consultations with on the standard pipe 421 case. We also had representatives from the Steel Industry Association of China. It was very much an introductory meeting, staking out some issues, and I think the main thing that we accomplished was that we got a sense of where we might be able to go with this dialogue and we will be working very closely with industry, with labor, with other interested parties in the U.S. now to plan out our next meeting of the Dialogue.

As we look at what we can discuss in that Dialogue, China's steel policy, like the overall Five Year Plan, stakes out some issues that we're very interested in.

Interestingly, when you talk with Chinese officials about their policies, the language they use tends to be the language of a planner and not the language of someone who is market oriented in the way they approach problems, and so there's a lot there to talk about.

How are they going to restructure their industry? What are the measures they're going to use? How are they driving their industry in particular directions? What measures are they using?

There are a lot of issues there. Again, in the steel policy as well as in the overall Five Year Plan, there is not a lot of specificity in terms of measures, but we hope through these types of dialogues to get a better understanding and to prod China in the direction of using market oriented measures rather than subsidies and other industrial policies that could be very detrimental to the United States and also to the global trade in a number of these items.

HEARING COCHAIR WESSEL: A quick question regarding the TPR. We had the transitional review mechanism, which China was, as I understand it, often refused to answer questions in writing. Sometime early this year or late last year, there were questions submitted regarding IPR that China indicated that the data was not appropriate for us to receive.

In the TPR of the U.S. recently, did China submit written questions and what are your expectations regarding the upcoming TPR? Do you expect that China is going to respond in writing to the 200 some odd questions that you've submitted, or the U.S. has submitted, and others I assume have done as well?

MR. STRATFORD: Yes. China took the position during the transitional review mechanism that this was a special mechanism just for China and that therefore the normal rules did not apply. We and other WTO members didn't necessarily agree with that, but the result of that was that they took the approach of answering questions orally rather than giving written responses to the transitional review mechanism questions.

However, it's very clear that in the Trade Policy Review process that the questions should be answered in writing. We don't, we haven't seen an indication from China that they think that they should be treated differently than other WTO members in this respect, and I can say that the United States worked particularly hard to do an excellent job in our own TPR this last month so that now I think everyone is expecting China to follow the normal practices and to reply in writing.

With respect to the intellectual property enforcement questions that you also referred to, this was our Article 63.3 request that we made last year. It's true that China's initial responses to us in writing were very legalistic and they're the sorts of thing that you'd expect a lawyer to say in a pre-litigation mode. In other words, they don't offer you very much.

We tried to get around that positioning by having a more informal discussion in Beijing, and in those discussions, the Chinese did agree to provide us some additional information. It certainly doesn't go to the entire length and breadth of what our original request was, but it did show some willingness to try to accommodate us, and we're in the process of receiving some of that additional information.

We'll continue to evaluate it as we get it. Again, we don't think that it's a full response to our request, but we think it's a beginning effort and that is somewhat encouraging.

HEARING COCHAIR WESSEL: Thank you.

HEARING COCHAIR BROOKES: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you very much, Mr. Chairman, and thank you, Mr. Stratford, for coming this morning and for your very full, excellent testimony. We appreciate the way that Ambassador Portman and you have leaned forward to work with the Commission on these matters and your comments on coordination with the Congress. When the Congress and the Executive Branch can reach a strong consensus on a foreign policy issue, the country is in much better shape to prevail overseas and this is certainly an area that that is applicable to our work.

It's very important that China comply with the letter and the spirit of the agreements that it has made in the WTO. Subsidies is certainly one key area because, in the long run, if they do not comply in a way that they should in terms of their importance in the trading system, it will affect the integrity of the WTO and our attitude toward the WTO as a mechanism that we can work with, and I think that's a very important question.

I'd like to ask about the pending case that's just been submitted in terms of automobile parts. Is there an issue of subsidies in the import offset requirements on auto parts?

In the past, what we understand is that the Chinese have hidden behind the defense that where there is a question of a defense, that the United States needs to go through a, quote, "exhaustion of remedies" in China before we go ahead and bring any kind of a case. A defense against that case is we haven't exhausted our remedies and attempts to solve the problem through the Chinese system.

So, first, is it the auto parts issue a subsidies case? —Second, is there a full record in terms of the case that we have actually brought, and have you made the record public in terms of the rationale and the argumentation that underlie bringing that case? It's a very, very important case. We commend you for doing that.

MR. STRATFORD: When China joined the WTO, one of their commitments was that they would eliminate a local content rule that was part of their original auto policy. After they joined the WTO, they worked to develop other rules that would, in effect, have the same impact as the original local content rules.

The way the rules work is that when they are trying to determine how much of a car has been imported, instead of looking at what arrives at the border, as presented to Customs at the border, they try to amalgamate everything at the actual automobile assembly plant, and this is not consistent with the accepted practice.

What they do in effect amounts to a new local content rule, which goes against their original obligation. There are a number of different claims under the WTO for attacking this. We think we have a very strong case.

One could say that it promotes import substitution and therefore could be a prohibitive subsidy, in a sense, but I think there are a lot of different ways to attack it in the WTO, and we think that we have a strong case.

We're not talking too much publicly about all of the arguments that we're going to make, but I think that we are confident and the Europeans have also expressed a similar level of confidence, that this is the sort of case that we'll prevail in at the WTO.

More generally, USTR has taken the position that we are willing to take cases to the WTO against China whenever two conditions are met. The first condition is that we need to be confident that we would win the case. The second condition is that we think that bringing the case would be the most effective way to deal with that particular issue, and so in our discussions with industries who have concerns about subsidies and about other matters, we have said that if you can help us put together the information and if we can evaluate it and come to the conclusion that we would win the case, then we are willing to take these sorts of cases to the WTO.

COMMISSIONER D'AMATO: Thank you.

HEARING COCHAIR BROOKES: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you very much, Mr. Chairman, and thank you very much, Mr. Stratford, for your very full testimony and for being here today. I had a question and a comment, and that is that oftentimes we view the Chinese government as purely economic maximizers. But of course they have so many dilemmas, and one of which is very starkly in front of us right now--the rural unrest and the new programs that have been announced by the Party to deal with that rural unrest.

The violent episodes of peasant rebellion, I think from the Chinese leadership perspective, may take priority over some of the trade issues and the economic maximizing policies. One direction that at least as far as I read the new Five Year Plan, to deal with this rural unrest is, in fact, subsidies to farmers and what we would call here in the United States, at least in that sector, a growing protectionist sentiment in order to deal with this unrest.

I'm wondering if you can link up for us this growing peasant and agricultural sector that is posing a big challenge to the Party and the progress we're trying to make in terms of market access and reduction of subsidies?

MR. STRATFORD: Yes. These are huge problems. The WTO Secretariat produced a report in connection with China's Trade Policy Review, as I mentioned, and one of the things that they mentioned in the report is that over the next decade, China will need to create over 100 million jobs to deal with the dislocation that is taking place in their economy.

Now, I note that last year, the United States, which is the strongest and most vibrant economy in the world, created two million jobs, and our unemployment rate went down and that was actually a pretty significant accomplishment. But China needs to create 100 million jobs over the course of the next decade. So that's a tremendous challenge.

The way to create those jobs is not necessarily to subsidize their industries. That allocates capital in an extremely inefficient way and is not sustainable over the long run. What they really need to do is carry out the types of reforms that will allow them to have a more healthy economy.

Now, a lot of the people who are working on the farms-- we have some evidence of some agricultural subsidies, but most of what we've been talking about and the questions that have come from the commissioners have related more to subsidies in the industrial areas.

We don't think that you need to create subsidies in order to create these jobs. We think that you need to open up your economy and allow market forces to operate, because there's a lot of potential in the Chinese economy that is being bottled in because of a lot of the restrictions. If they allowed greater market access in the services and in other areas, we think that our investments there would help to create a lot of jobs that would be catering to the Chinese economy itself and not necessarily result in increased surges of exports back to the United States.

So we agree that certainly there are huge problems that the Chinese leadership needs to be looking at, but we think that fixing their currency system, their financial systems and having greater reform and opening will lead to greater growth.

I reflect in particular on my own experience in the auto industry. The Chinese auto industry was amongst the strongest critics of, internally in China, of some of the commitments China made to join the WTO. But since China joined the WTO, the Chinese auto industry has enjoyed tremendous growth; it's created a lot of new jobs. Most of this has been focused on the Chinese domestic market itself rather than on exports, and that I think is a great example of what happens if they will abandon their industrial policies and allow market forces to create the sort of jobs that they need for their economy to be sustainable on a long-term basis.

COMMISSIONER BLUMENTHAL: Do I have time for a follow up question?

HEARING COCHAIR BROOKES: I think we're going to go through everybody first since we're running out of time. Commissioner Mulloy and then we'll go to a second round if we have time.

COMMISSIONER MULLOY: Thank you for being here, Mr. Stratford, and I salute Terry McCartin who is here with you and helping in this process.

On page four of your testimony, when you talk about this Trade Policy Review in the WTO, help me understand what will be the product of that? I read either in "Inside U.S.-China Trade" or "Trade Daily" that preliminarily they even are talking about exchange rates in that TPR report and review that's going on in Geneva.

So the question is when this is completed and we get our 200 questions asked and then you lay out what has happened and what are the problems, is that a road map then for bringing some WTO cases if we don't get movement by the Chinese? Is that a likely result that you can find problems and maybe bring some cases if we don't get some movement just discussing it within this mechanism? Is there a formal written report that comes out of this process?

MR. STRATFORD: Well, we have the written report from the Secretariat and then we will get written answers to the questions that have been submitted not only by--

COMMISSIONER MULLOY: You have the written report now?

MR. STRATFORD: The Secretariat's report has been issued, but that's something that happens at the beginning of the process. That report goes out to members and then the members have a chance to submit questions, and then in the meetings, China provides the written answers and there's a chance for discussion in the meetings that are scheduled on the 19th and the 21st in Geneva.

Obviously, China doesn't hope that we sit there, taking notes, and then rush right over to the next office and file WTO claims against them because of the information they've just given us.

Realistically what we will do is assess the information. Where we have concerns, we'll discuss the concerns, and if we don't see responsiveness to address real concerns, then we will certainly consider other options.

But we hope that we can draw China into a dialogue that will be constructive, and if we can't, then we certainly wouldn't rule out WTO cases as well where we think that they're warranted.

COMMISSIONER MULLOY: Am I correct in my recollection that this draft report, which is prepared by the Secretariat, discusses the undervalued yuan?

MR. STRATFORD: There is some discussion of current valuation in the report.

COMMISSIONER MULLOY: Article 15.4 of the WTO Agreement provides that you are not supposed to be manipulating your currency to gain trade advantage. So I remember Mr. Lamy at one point opined that maybe it wasn't possible to bring an exchange rate case in the WTO. I was at the hearing last week when Mr. Adams testified before the Finance Committee that the IMF is the preferred mechanism.

But as I analyze it, you can bring a WTO case and then get it referred to the IMF for their advice on the exchange rate issue. Is that your understanding?

MR. STRATFORD: We haven't felt that pursuing that course would be the most effective way to deal with currency cases right now. Again, I'd rather not go into detail on some of the other options because I don't think that USTR is the right party to give the most definitive response to that question.

COMMISSIONER MULLOY: So out of the mechanisms so far, we have this report from the Secretariat, now there will be further discussions based on these questions. Will there then be another written product from the Secretariat or do we have what we're going to get?

MR. STRATFORD: We'll get the written answers from China to the questions and so we'll have the Secretariat's report and the written answers.

COMMISSIONER MULLOY: Are there a lot of other people asking questions as well?

MR. STRATFORD: Yes, there are. China has its work cut out for it. Obviously, China's trade affects a lot of countries. There are a lot of countries that have concerns, that have questions, and China's going to have a great learning experience as they go through their first TPR.

COMMISSIONER MULLOY: Are those questions and answers available to our commission?

MR. STRATFORD: I think they'll be publicly available. Yes, ultimately, they'll be made public.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR BROOKES: Thank you. Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Tim, you said that you had made to the Chinese the argument that using the rules and litigation is a sign of a mature relationship. What was their response?

MR. STRATFORD: At the working level, say at my level, people understand that. And the people that we tend to deal with spend a lot of their time trying to educate other parts of their government with the importance of WTO obligations, and they recognize the value of WTO dispute resolution because it's a way that governments can take a problem and turn it over to a neutral objective process. Frankly, it can give political cover to government officials.

So this is recognized, and people recognize that it could be useful to have a WTO ruling on a particular matter to help them in terms of interagency coordination to ensure compliance.

Having said that, they certainly don't feel that their senior leadership necessarily understands this process and believe that it will take a period of time before they recognize that this is normal and not intended to be a hostile act against China. So this is a matter where I think we'll continue to need to do some explanation, but I will say that thus far, China's reaction to the auto parts case has been relatively muted, which I think is an appropriate response, and so we hope that we can continue along that basis.

COMMISSIONER REINSCH: Good. You also said that you were going to enhance your agency's trade enforcement capacity. What does that mean?

MR. STRATFORD: Well, first of all, as we talked about and review talks about, we have created a China Enforcement Task Force. The task force is cochaired by a Chief Counsel for China Enforcement who reports to the General Counsel. We now have Stephen Kho, who is acting in that position

COMMISSIONER REINSCH: Is there something beyond what you've already announced that you're referring to?

MR. STRATFORD: No, but what I will say is that this task force is actually going to be very active and very engaged. We see the first case that's been announced, and certainly we are looking at the viability of other cases.

COMMISSIONER REINSCH: Okay. Bring me up to date--what is the administration's current position on the application of the CVD law to subsidies in non-market economies?

MR. STRATFORD: Well, as you know, this is administered by the Department of Commerce.

COMMISSIONER REINSCH: I assume you talk to them from time to time?

MR. STRATFORD: We do. Some of my best friends work for the Department of Commerce.

COMMISSIONER REINSCH: Mine too.

MR. STRATFORD: I'm sure. So far they are not applying CVD toward dumping cases. We haven't seen any particular indication that they're doing so. As you know, there is legislation pending that could require that.

COMMISSIONER REINSCH: Yes. Has the administration taken a position on that particular provision of the legislation yet?

MR. STRATFORD: I don't think there has been a clear position. I think what we have said about it is that it raises complicated questions in the interplay of a non-market economy status and the way you do the dumping determinations, and then to try to have countervailing duties at the same time, that it raises certain complexities, and therefore it needs to be looked at very carefully, particularly by the Department of Commerce.

But I think that's all that the administration has said so far. It has not taken a firm position either for or against such legislation.

COMMISSIONER REINSCH: I've got another one, but I can't see the clock, Mr. Chairman. Do I have any more time or am I gone?

HEARING COCHAIR BROOKES: You're just about out.

COMMISSIONER REINSCH: I surrender then.

HEARING COCHAIR BROOKES: You've been very gracious with your time, Mr. Stratford. We have one last commissioner to ask questions. Also, there's an opportunity for commissioners to submit written questions as well. MR. STRATFORD: Certainly.

HEARING COCHAIR BROOKES: But at this moment, I'm going to try to stay on time, we'll ask Commissioner Houston to close.

COMMISSIONER HOUSTON: Thank you. Mr. Stratford, thank you so much for taking time out of your day to be here with us. It has certainly been educational. It seems that the key to this is to balance hopeful expectations and political realities.

As a free market public policy analyst, I'm struck by the challenge of a market economy trying to exist in a non-market political system. From our expectations, we are looking for market reports from a non-market political system rather than from the industrial base of the country itself as these two things certainly seem to be so interwoven.

I have two very quick questions for you as far as that level of challenge goes. One is do you have any sense, and certainly not a number we would hold you to, but any sense of what percentage of non-multinational economic activity in China right now would be heavily subsidized by the government. And also as Commissioner Reinsch mentioned, whenever we talk about challenges with trading partners, we talk about strengthening, encouraging, remedies, all these kinds of things, it seems that we have two levels of play here. One is with our own U.S. trade and one is also with WTO compliance.

So my question would be both from the USG perspective as well as from the WTO perspective. If there is noncompliance by China, both on the subsidy notification, the TPR, or any other sort of trade issues, what is it possible to do, both by the U.S. government and WTO, and what would you anticipate politically and sensitively could be done?

MR. STRATFORD: With respect to the scale of subsidies operating in the Chinese economy, I think it's very difficult to give a precise answer. I think that a lot of the practices that have been mentioned by commissioners in their opening statements, for example, they're pretty widespread.

Even the collection of income tax, foreign companies have a feeling that they're held to a higher standard in terms of calculation and payment of income tax or a lot of other factors that take place as a natural course of doing business.

I think that some form of what you might call a subsidy impacts very, very broadly in the economy. Just the fact that some laws are not enforced very rigorously in some areas. Maybe some domestic companies are not required to go through the same rigorous testing to standard certification or things like that.

This strengthening of the rule of law and their enforcing of their laws, whether it's tax collection or the way they deal with collecting rents for property or a whole range of issues, can affect businesses very generally and, in general, foreign companies are held to a higher standard, and we're used to following the laws and expect it of ourselves as foreign companies.

So I think it's very broad, but the number of these things that would actually amount to actionable subsidies, prohibited subsidies under the WTO, probably would be a much smaller subset of that. In order to say that these broader types of subsidies would be actionable under the WTO, that would be an extraordinarily difficult case to collect the date and then to show in some systematic way that it was resulting in injury in our own markets.

So I would say it's a broad problem, but the part of it that we're really concerned about from a WTO perspective would be some subset of that. But again, that subset I think is significant and something that we really need to be focused on.

COMMISSIONER HOUSTON: And what about the question as to what the potential mechanisms for remedy are if there is noncompliance?

MR. STRATFORD: I think you're speaking specifically of the subsidies notification. I think I've talked about the fact that the administration has concluded that China is moving into a new phase and there should be greater accountability enforcement. I think it's fair to say that this is not just the United States assessment, but I think the broad range of WTO members have had the same experience as the United States has.

That is to say they've seen that they've had some very good benefits of their trade relationship with China and they've seen some problems that have been rather persistent and perhaps intransigent, and I think that there's a broad consensus forming that China needs to be taken to account on certain things.

What that means is as we talk with other WTO members, we can explore other ways to put pressure on China that may come short of actually filing a WTO case, and we are looking at doing those sorts of things, because, again sometimes the best way to get where you want to go is by nudging rather than hitting over the head with a baseball bat.

Having said that, we don't have unlimited patience on these things, and we would consider all options including WTO dispute resolution process if that ultimately became necessary. And as I say, we don't have unlimited patience on this because of the effect that it has on our own industries and our own workers in the United States.

HEARING COCHAIR BROOKES: Thank you very much, Mr. Stratford. On behalf of the commission, thank you for your time, for your service, and we wish you well in advancing America's trade interests.

MR. STRATFORD: Thank you.

HEARING COCHAIR BROOKES: Without further ado, we'll take a five minute break and then move to the next panel. [Whereupon, a short break was taken.]

PANEL II: CHINA'S WTO ACCESSION AGREEMENT AND U.S. LAW

HEARING COCHAIR BROOKES: Our second panel this morning will deal with China's WTO Accession Agreement and U.S. law. Joining us this morning is Dr. Loren Yager, Director of International Trade at the Government Accounting Office here in Washington, D.C.

Thank you very much for joining us. If you could give us your statement in seven to ten minutes, that will give us the maximum time for questioning and get you out of here on time. So we'll turn it over to you. Thank you.

STATEMENT OF DR. LOREN YAGER, DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

DR. YAGER: Thank you very much. It's good to be back in front of the Commission. Good morning, Chairman Brookes, Chairman Wessel, and other members of the Commission. Thank you for the opportunity to appear again before the Commission, this time to talk about our recent reports related to better understanding in addressing Chinese subsidies.

As you know, we've completed a number of studies that are relevant to the subject of this hearing, and I'm happy to share some of those insights with the Commission this morning.

So before I begin, let me spend a few moments explaining what I believe are GAO's key contributions as well as the limits of our input to the Commission and to the debate more generally.

We have stated in prior testimony before this Commission that U.S. government efforts to ensure that China complies with its WTO commitments will require a sustained approach.

In our earlier studies, we have reported on U.S. monitoring and enforcement of China's WTO commitments, and I can answer questions on those topics if you're interested.

However, in terms of our unique contributions, I believe that laying out the options and the challenges that Commerce has in applying CVDs to China is important. Equally important is our analysis of the potential implications of applying CVDs to China. These findings together with insights from your own panels today should contribute to more informed decisions by the Congress on this issue.

The GAO contributions are based primarily on the findings of the study that we published on the use of countervailing duties against China, and we performed this work for Chairman Frank Wolf, the House Appropriations Subcommittee Chairman.

I also want to be clear about the limits of our analysis. GAO is neither in favor nor opposed to the application of CVDs against China. We also do not take a position on any of the legislation that has been proposed to make CVDs applicable to China.

Those judgments involve tradeoffs between different groups in the United States, such as between consumers and producers, as well as between different producer groups. We believe those tradeoffs should be informed by analysis and we've made recommendations on the basis of that analysis.

But ultimately the decisions on whether to apply CVDs and by what method must be made by elected officials.

Today I will focus my remarks on three issues. First, I will describe the policy options currently available for applying CVDs against China. Second, I will discuss the challenges of doing so, and finally I will summarize the likely results of applying CVDs to Chinese products.

As we detail in our report, the current Commerce policy of not applying CVDs to countries with non-market economies including China rests on two principles advanced in 1984 and confirmed by federal appeals court.

These two were that Commerce lacks the explicit authority to do so; and two, Commerce cannot arrive at meaningful conclusions regarding subsidies since the government rather than the market determines prices.

Let me now summarize the three key points of our analysis. The first main point from our report relates to Commerce's options. Commerce could choose one of two paths to apply U.S. CVD laws to China.

Following the first path, Commerce could reclassify China as a market economy or individual Chinese industries as market oriented and apply CVDs against China on that basis.

Commerce has criteria for such determinations. Commerce officials told us that China is unlikely to satisfy those criteria in the near term.

Following the second path, Commerce could reverse its 1984 position and apply CVDs without any change in China's NME status. However, the appeals court raises serious doubt about Commerce's ability to make such a change without a clear grant of authority from Congress. Such a decision could be challenged in court with uncertain results.

The House passed legislation that would grant this authority in July of 2005 and companion legislation was introduced in the Senate. World Trade Organization rules do not explicitly preclude either alternative.

The second main point from the report is that Commerce would face substantial challenges in determining appropriate CVD levels against Chinese products. I'm sure your afternoon panels will talk about this in much more detail.

Chinese subsidies remain very difficult to identify and quantify, largely because of the structure of the Chinese economy and the lack of transparency in the country's subsidy regime.

Not only is it difficult to do, but Commerce has no directly relevant experience and little guidance in place to indicate how it would proceed. It may be able to overcome these challenges, at least partially by using third-country information to create benchmarks as part of its methodology for measuring subsidy benefits.

Or by employing facts available to complete cases in which foreign parties cannot or will not provide needed information. However, these approaches would not fully resolve the methodological challenges that would face Commerce. Moreover, under current law, Commerce lacks explicit authority to use third-country information in CVD cases against China as provided for in China's WTO commitments.

The third major point from the report is that it's unclear whether applying CVDs would provide greater protection than U.S. producers already obtain. There is no question that making CVDs available against China would give U.S. producers an explicit import relief measure that targets unfair government subsidies.

However, some of these subsidies are likely to be captured already indirectly in the form of antidumping duties calculated using the NME methodology. CVDs alone tend to be lower than antidumping duties. Our data indicate that the average CVDs were 13 percent and antidumping duties were 26 percent.

However, these averages don't tell the whole story. There are some complexities. For example, if CVDs and antidumping duties are applied simultaneously, required methodological changes would mean that AD duties would likely decline. It is not clear whether CVDs would compensate for these reductions.

In addition, Commerce is required to reduce duties to avoid double-counting when export subsidies are involved. But Commerce lacks clear authority to make such corrections when domestic subsidies are involved.

As I mentioned in my opening statement, GAO does not take a position on whether to apply CVDs. However, we believe that certain steps by Commerce and by the Congress would be beneficial if the decision is made.

For example, we made recommendations to Commerce to analyze and report on its ability to measure Chinese subsidies and the methodologies it might use to do so. We also asked Congress to consider clarifying Commerce's authority to use third-country information in CVD cases and to make corrections to avoid double-counting of domestic subsidies.

In response, Commerce took the position that there is no explicit statutory bar to its application of CVD law to non-market economies and stated that the Department would carefully consider any CVD petition. However, given that Commerce determined in 1984 that it did not have explicit legal authority to take such an action and that this was subsequently upheld and affirmed by a federal appeals court and later confirmed by a 1994 statement of administrative action, we continue to believe that there would be legal obstacles to such a change in Commerce policy.

Commerce cited some legal authority for using external benchmarks in CVD cases. We're not convinced that the cited authority would clearly provide for full implementation of the special methodology in China's WTO accession agreement. An explicit grant of authority by Congress would remove doubt and lessen the chances for legal disputes. Therefore, we continue to believe our suggestion is prudent.

Commerce also said that our suggestion that Congress provide them with authority to correct any double-counting of domestic subsidies was not warranted or appropriate. We maintain that our analysis shows that there is substantial potential for double-counting of domestic subsidies if Commerce applies CVDs to China while continuing to use its current NME methodology to determine antidumping duties.

We believe that in such a situation, Commerce should be provided authority to proactively address potential double-counting whether than waiting for it to occur and creating methodological and legal problems.

Mr. Chairman, this concludes my testimony. I'd be happy to take any questions that you or other members of the Commission may have.

[The statement follows:]

Prepared statement of Dr. Loren Yager, Director, International Affairs and Trade, U.S. Government Accountability Office[1]

PANEL II: Discussion, Questions and Answers

HEARING COCHAIR WESSEL: Thank you, Dr. Yager, for being here, and for all the cooperation that you and your entire team have given to this Commission over many years.

You've helped us understand many facts and many projections and approaches that people want to take and we appreciate that. Let me though go up to a higher level with regard to this, in the sense that China agreed as part of its accession commitments, and Mr. Stratford talked about this earlier, to notice all of its subsidies.

It has yet to do so five years after those commitments were made. They now tell us they're having translating problems in terms of what their subsidies are, which, as Mr. Stratford said, we're beginning to offer translating help if they need it. I don't think that will be terribly effective.

Rather than going on a case-by-case basis which you've just run us through in terms of what the law is, is there a broader WTO response that's available that does not rely on U.S. law but rather WTO codes, protocols, et cetera, that would enable us to get at this in a more global sense?

Or are we at the end of the day always put back into a bilateral setting that then forces us to go back to the WTO for adjudication at some point if our trading partners complain about it?

DR. YAGER: Well, I think it's obviously very important that you had USTR here because they are really the agency that has to answer those questions. They have the authority. They have the different mechanisms and tools by which to put pressure on China to help to address some of these problems.

Now, some of the tools that they have obviously involve the WTO such as the TRM, and I think in some of our prior work, as you probably know, we made some recommendations to USTR to try to be more effective in using the TRM mechanism, trying to engage other countries rather than just the United States in asking the questions, doing that somewhat more systematically to give China more time to respond and provide the kinds of answers that we look for.

But as you know, the TRM mechanism, while it is a useful multilateral tool, it seems to be a better location to ask questions than necessarily to get answers, and I know a lot of the members of Congress have expressed their disappointment. It's fallen short of their expectations.

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[1] U.S.-China Trade: Challenges and Choices to Apply Countervailing Duties to China. Statement of Loren Yager, April 4, 2006.

When we did some work on China's accession, some of the issues that we really looked at very closely were USTR's capacity in its organization to put pressure on and to bring forward the kinds of issues that members of Congress and others have been concerned about for so long.

The last report we did on this issue is now a couple years out, but I think we certainly saw some action on the part of USTR in trying to respond to our recommendations, and I think there has been a flurry of changes over the last few months which also indicate that USTR is gearing up for a more active role.

But one of the other things that we pointed out in our work on China's compliance is that the way that the United States does that function seems to shift over time. A year or so ago, there was a great deal of high level activity, secretaries going over and visiting, and now it appears to be through the "Top-to-Bottom Review" and through other mechanisms and possibly a case. So there does seem to be changes over time and a lot of attention being paid to that issue by the USTR.

So we think that certainly is responsive to the points that we made in our prior report.

HEARING COCHAIR WESSEL: But non-responsiveness in China in this setting does not yield sanctions. It's a review mechanism that unfortunately, I think, puts us back into the litigious approach to this at the end of the day.

As it relates to the potential legislation, and I've seen your reports and the responses to that, how does that change, if in any way, our ability to gain data? We're probably going to be set with doing proxy rates; is that correct?

DR. YAGER: Right. Commerce has a couple of ways to try to collect that information. One of the things that we did, we actually recommended to Commerce that they put together a paper to demonstrate how they might do this, what kind of information they would use, and to do some studies. As you know, when Commerce makes these kinds of judgments and determinations, they rely a lot on precedent, and in this case, if you're going to go ahead and begin using CVDs against China, those first couple of situations are going to be very difficult.

The rules have to be written. They have to understand what their options are. We made a recommendation which Commerce did not agree to, to do a little bit of that work and try to anticipate the problems and make some of those judgments, to determine what kinds of third-country benchmarks and other information might be useful.

We point out in our report that Commerce has done that for other types of import remedies. I believe there is a dumping guidelines book that Commerce has published, so we do believe that Commerce could do that even in the absence of a single case, which they believed was necessary. So we think that Commerce is really the agency that needs to think through how it might do that.

Maybe your panels this afternoon would help provide some guidance on that as well, because we didn't see the evidence that Commerce was moving forward in trying to understand what kind of information they might use and what the likely results would be.

HEARING COCHAIR WESSEL: So essentially developing an investigatory schematic upon how we would look at these cases, how we would gain information, to be able to determine whether they're successful or not?

DR. YAGER: That's right. And of course, Commerce does have some options in using facts available and other techniques and we think it would be useful for them to go ahead and lay that out, to see what the effects and what the methodologies might be.

Again, it doesn't have to be case specific and they have done that in the past with broad guidance and we think it would be a very useful exercise for them as well as for others to observe to see whether that, in fact, makes a difference and whether that's going to bring the kind of relief that people would expect.

HEARING COCHAIR WESSEL: Okay. Thank you.

HEARING COCHAIR BROOKES: Thank you. Commissioner Mulloy.

COMMISSIONER MULLOY: Dr. Yager, thank you for being here and thank you for Adam Cowles and all the help that GAO has given this Commission over the years.

I also want to salute you and the GAO for the help that you've given to the Senate Banking Committee in their CFIUS legislation. To build a report, it relied a lot on the recommendations that GAO made to them. The two situations are not entirely unrelated. When we have these huge trade deficits with China, China accumulates dollars, and then they come back and make acquisitions in this country. So the investment and CFIUS is totally related to the trade issue.

Congressmen Hunter and Ryan have introduced a bill, and I think they now have over a hundred co-sponsors in the House to make exchange rate manipulation or undervaluation of your currency a subsidy and then to make our countervailing duty laws applicable to China.

Have you analyzed that legislation? Do you have any views on whether that might be an effective way at going after the undervalued currency in China?

DR. YAGER: I do appreciate the comments you made. The staff that we have in addition to Adam Cowles that have worked on a whole series of these import remedies, China's import remedies, includes a bunch of very talented people, economists, lawyers and others, and we wouldn't be able to do the work that we've done without those kinds of folks. So I appreciate the comments that you've made.

COMMISSIONER MULLOY: They've come up and briefed us, which we very much appreciate.

DR. YAGER: Right. With regard to using currency or having Chinese currency be countervailable, we haven't done any specific work on that, but there's a couple of things obviously that would make that different than the typical CVD case. First, of course, is the breadth and the fact that this is not necessarily a specific subsidy, that it appears to provide some benefit to a broad range of exporters rather than a particular firm or a particular industry, and I think that would have implications for the way the petitions come forward as well as the way that the Department of Commerce responds to those.

So obviously it's a fairly significant change in the CVD application. Again, we haven't looked at it in detail, but I think it does raise much broader kinds of questions because of the fact that it is a very big change to what is currently being done.

So we certainly could think a little bit more about that, but at this point, we have not done an analysis of the legislation.

COMMISSIONER MULLOY: Have you done any analysis of whether you can bring a WTO case on the exchange rate issue relying on Article 15.4 in the GATT and then Article 4 of the IMF?

DR. YAGER: We have not done work on that. We tend not to try to raise questions that are directly relevant to court cases. We try to stay away from providing that kind of guidance. That's really the role of the administration to make those decisions rather than GAO. So that's the kind of question we probably are not particularly comfortable in trying to answer.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR BROOKES: Thank you. Chairman Wortzel.

CHAIRMAN WORTZEL: Dr. Yager, thank you very much for your testimony. It was very helpful. I have some questions about antidumping calculations.

It strikes me that India may not be the best surrogate. I agree that both the Chinese economy and the Indian economy started out Stalinist, centrally-planned and centrally-controlled. But in some sectors of the Indian economy, particularly the newer sectors of the Indian economy, such as IT, and financial services, there was no government planning or regulation when they sprung. Also, they developed away from New Delhi. Therefore, they function on a market basis.

Another difference between China and India is there's no single overarching authoritarian political party that can control central planning and government policy in India.

It seems to me that Vietnam or Cuba, the places that do have single authoritarian parties that can set whole ranges of policy, might be better surrogates; although I accept that there's parts of the Chinese economy right now that may be completely running on the market.

Can we explore this line of thought? I recognize it's a little bit of a philosophical question given what you're stuck with in legislation.

DR. YAGER: Let me just make a couple comments. One, we certainly are thinking about some of the questions that you raise with regard to the comparisons between China and India. We happen to be in the middle of a project right now which is looking at the development of manufacturing, particularly in semiconductors in China and comparing that with the growth of services, particularly information services in India and coming up with a lot of the same observations that you have.

I think one of the things that is important here, maybe it doesn't follow, because India does have more market mechanisms in some ways but maybe not nearly as well developed in others. They don't have the infrastructure and other things, but having a country that does have some market signals is actually what you're looking for because it allows you to put prices on the kinds of production processes and others that you need in order to build a value for a particular product.

So I think some of the challenges that come with India, for example, if you're looking at some of the higher tech sectors, particularly in manufacturing, whether it's semiconductors or others, using India as a surrogate there is quite difficult because they just don't have those sectors. Those sectors are way behind the Chinese in terms of their development and they don't really have the market participants that China does, for example, in semiconductors or some other high tech trade.

I wouldn't say that the biggest challenge is the different levels of government involvement. I think it actually has to do with the fact that there are few countries in the world that have the kind of manufacturing capability that China has, particularly in moving into these high tech sectors. I think that is going to be a significant problem.

When you think about trying to come up with a third country with, for example, CVD on semiconductors, things like that, India is not a particularly good proxy because they don't have the infrastructure, they don't have the clustering of firms that is rapidly growing in China.

Clearly there are some problems and again I go back to the recommendation we made. It's one thing to have the challenges, as you'll hear about this afternoon from some of the experts on the Chinese economy, but the other thing that we know a little bit more about after having read all of these, the different kinds of petitions in the answers of Department of Commerce is that they have a very special way of doing their methodology.

We think that's going to be a big challenge in trying to apply it. We think that they should get a head start, do a little bit of work in advance, put that out for people to take a look at, get comments on it, and we think that's the way to go because there is no question it's going to be a challenge.

CHAIRMAN WORTZEL: I got permission from Commissioner Brookes to follow up on that. And it strikes me that there are places that have similar central planning and high levels of single party control or dominant party control, that do have a great clustering of specific industries in that area, and for me, Singapore and Malaysia come to mind, but are we better off with mixed surrogates?

DR. YAGER: I guess part of the question is what you would mean by better off? If better off means that you're going to--

CHAIRMAN WORTZEL: Approximating reality.

DR. YAGER: Right. Well, then I think you would want to be flexible to determine which country has those types of mechanisms that would allow you to get some shadow prices or other benchmarks, and I think that particularly in a high tech sector, you would have to look to countries other than, for example, India because while they're advancing very rapidly in the services area, their manufacturing is, as everyone knows, quite a bit behind.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR BROOKES: Thank you, Mr. Chairman. Commissioner Reinsch.

COMMISSIONER REINSCH: I'd like to chat for a minute about the non-market economy criteria in the statute. I think you stated, and I certainly would agree, that there's not a lot of dispute that China doesn't meet the criteria for a market economy designation.

Is that your view?

DR. YAGER: Yes. We've raised that question directly with the Department of Commerce, and they said that there's no--well, it doesn't look like they're going to make it in the near term. I guess it's hard to know exactly what that means, but it's not imminent.

COMMISSIONER REINSCH: Well, did they suggest what the Chinese would have to do in order to meet the standard from Commerce's point of view?

DR. YAGER: Well, the key points that apparently are being used, the criteria to make those decisions are:

The extent to which the country's currency is convertible--obviously, you're having a whole panel on currency;

The extent to which wages are determined by free market bargaining;

The extent to which joint ventures and other investments are permitted;

The extent of government ownership over the means of production;

The extent of government control over the allocation of resources;

Then, of course, there's the catch-all: other factors that Commerce considers appropriate.

I think on a number of these criteria, Commerce came back and said we don't believe that China is close to making this kind of a step. Interestingly, China has not actually asked the United States to consider it as a market economy. China did ask the EU and the EU made a determination that they were not a market economy and that was relatively recently. So there is no formal review ongoing right now.

COMMISSIONER REINSCH: Are the EU criteria significantly different from ours?

DR. YAGER: I actually haven't read what the EU criteria are, but I would have to imagine that there would be some significant overlap between our criteria and their criteria simply because this seems to cover the major influence that a government might have on an economy as compared to a market.

COMMISSIONER REINSCH: I was going to say I came to the same conclusion. That's logical. That leads to my next question. Do you think these are the appropriate criteria?

DR. YAGER: I think these make perfect sense. The major point that Commerce made in 1984 in Georgetown Steel was that the involvement of the government was so pervasive that it didn't make sense to try to use the prices that were created within that economy. For example, that really talks about the extent of government control over the allocation of resources and their pricing and output decisions.

To the extent that the government influences those decisions in a profound way as it appears to do in China, then they seem to be a long way off from achieving that market economy status.

COMMISSIONER REINSCH: Do you buy the concept that's been proposed from time to time of the island of capitalism, the theory that a sector might meet the criteria by itself even though the whole economy does not?

DR. YAGER: I would think that there certainly is some potential for that to occur. I think that there needs to be, frankly, more transparency with regard to the country's economy because one of the problems that you have is given that you've got a large state involvement in the economy and you have a lack of transparency, it actually takes some significant kinds of transparency and changes within whatever sector it is that you're most interested in so that you can see that there are no significant benefits to firms or to particular industries.

So I think transparency or the lack of transparency is going to make it difficult to reach that kind of a conclusion even on a specific industry basis.

COMMISSIONER REINSCH: I agree with that. The Chinese have made the case from time to time. I think the menthol case was the first time they did it, and the department has never bought it. I'm not sure that it's logical if, for example, one of your criteria is a currency peg, it's hard to escape that even on a sectoral basis, but it's an interesting question. I think it's going to come back up.

The only other thing I'd say is just to thank you for the data that you provide in the study you did, particularly with respect to the contrasting AD and CVD duties. I take it your conclusion, just to clarify it, is that it's really hard to tell what the actual consequences of changing our rules would be.

DR. YAGER: I think the way that I summarized it when I was thinking about the larger questions of this hearing is that really are a few different kinds of issues that you think about when you're talking about the advantages and disadvantages or maybe costs and benefits of applying CVD.

The first one has to do with the fact that the way that costs and benefits are conditional on what method is being used to use CVD. So, for example, if it comes because of Commerce's decision to classify China as a market economy, then that has significant implications for AD methodologies. So one of the key issues here in cost and benefit is what path is taken.

The second thing that I think is important to think about is that there is uncertainty involved with all of the different ways of trying to move towards using CVDs. In some cases, it's legal uncertainty. In other cases, it might be the methodological uncertainty because of the kind of double-counting changes.

Finally, I think that the outcome of this obviously will be different for different groups. There may be certain types of industries or firms whereby the CVD would offer them an alternative that has real advantages over antidumping, but trying to predict the future even based on the very careful analysis that we did and trying to match up antidumping and countervailing duties depends on what cases are brought and what the findings are at the Department of Commerce.

So it seemed to me there were three things that you really had to think about in order to make an informed decision about this, and that had to do with what path Commerce takes, the uncertainties involved, particularly legal and methodological, and finally where you are in the economy this could make you better off or worse off. And that's what we were adding to the debate.

COMMISSIONER REINSCH: DI'm just sort of bemused by this. I don't think it's likely for the reasons you've just described that Commerce any time soon is going to declare them a market economy. So it seems to me the choices are, one, the status quo, which is obviously a choice, or, two, to start applying CVD law to them even though they are not under the statute a market economy.

I'm just wondering in that case, it seems to me a little bit like we're arguing that for dumping purposes, they're a non-market economy because we want to maintain those rules, but for subsidy purposes, they're a market economy because we want to apply the CVD law. Doesn't that strike you as a little bit odd?

DR. YAGER: One of the things that we also recommended was actually for the Congress to make, to have input here and provide Commerce with more explicit authority to do that. It does not appear to be contrary to any WTO rules, and so we felt that if Congress decided to or had an interest in applying CVD, that they should clarify some of

Commerce's legal authorities in order to reduce some of the uncertainty that might be involved.

If Commerce were to go ahead and make the decision and begin applying CVD without declaring China a market economy, then we think there are some legal obstacles, and there could be cases, and we think it would be better to have that explicit legislative authority provided to Commerce so that then they could make that change and that particular source of uncertainty would be significantly reduced.

COMMISSIONER REINSCH: That would certainly be a better way to do that. Yes, I was thinking more economically than legally. But I think my time is up.

HEARING COCHAIR BROOKES: Yes, thank you. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Dr. Yager, you've done some really good work on the Transitional Review Mechanism in the WTO. That was the special provision that put China under an annual review I think for the first eight years and then one final one.

We went to Geneva and talked with officials there. We talked with the Chinese Ambassador to the WTO. I think it was Ambassador Sun. They stated quite clearly that they felt that was discriminatory even though it was part of their Accession Agreement. They stated quite clearly they felt that was discriminatory, and I don't think they cooperated very well with that annual review.

When we were there last, the GAO or the WTO told us, well, don't worry because they've grown so fast as a trading partner, they are now subject every two years to this other review which is called the TPR. That's what's going on now and which will, I think, take place over there in late April.

Have you received any request from the Congress to evaluate the TPR process and what it's coming up with as opposed to the work you've already one on the TRM?

DR. YAGER: At this point, we have not been asked to look at the Trade Policy Review. We understand it has some significant advantages over the TRM. The TRM, as I think I mentioned earlier, there were a lot of good questions being raised, especially in the November meetings. It looked like it was not just the United States. Mexico, Canada, the EU were involved in providing some of those questions.

So we think that there has been some useful, at least discussion created or a record created, but unlike the TRM, I think the Trade Policy Review really does require China to respond, and as you know, that's been one of the big problems with the TRM.

There has been good questions put forward, some useful discussion by the United States as well as by other countries, but frankly the answers have been less than satisfying to most parties involved. Hopefully there will be more impetus and a stronger requirement for

China to provide answers when it comes to this new review, which again, as you mentioned, will now be every two years.

China has joined the ranks of the top traders in the world, so it is subject to this review much more frequently than would have been the case.

COMMISSIONER MULLOY: Would you welcome a request from the Congress to do an evaluation of the TPR?

DR. YAGER: I guess one of the questions that we often ask in situations like that is what is the best timing, what is the most opportune time for us to do work like that.

COMMISSIONER MULLOY: When do you think it would be?

DR. YAGER: I think in some cases, it probably makes sense for us to be able to see a report to find out how it has actually fared, so trying to do it in advance probably wouldn't give as much value as looking to see how the process went forward and what it resulted in at least during one cycle. So I think that would probably be the opportune time for us to do that kind of work.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR BROOKES: Thank you. Chairman Wortzel.

CHAIRMAN WORTZEL: I don't mean to overburden you, but I'm learning a lot. You've intrigued me when you said that China has not requested the United States to grant it market economy status and also the EU.

DR. YAGER: They did request the EU; right.

CHAIRMAN WORTZEL: Right, but the EU did not.

DR. YAGER: Right, they did not.

CHAIRMAN WORTZEL: Why did they then push so hard with Brazil? Can you give me the logic for that behavior?

DR. YAGER: I'm afraid I can't. I really can't answer why those decisions were made in such a way. I certainly can look at the criteria that we provided and said it does appear that China has a long way to go on those five or so criteria, but in terms of comparing this with Brazil or other countries that have been provided a market economy status, I don't really have the insights into how that decision was made. I think it is a very interesting question though.

CHAIRMAN WORTZEL: Can you determine whether they in a particular sector derived great benefit from Brazilian trade laws from having been declared a market economy?

DR. YAGER: I think there are probably a couple of things that would be at least perceived as very important to China as well as to other countries. I think China looks at this in some ways as a symbol of achievement to be declared a market economy, and so I think there's a certain amount of status involved with a decision like that, and I wouldn't discount the importance of that.

I think the other is that frankly maybe they had a sense before we did some of the detailed work on both countervailing duties as well as antidumping levels, that it may be better to have CVDs applicable against them, but get out from underneath this methodology that's being used to calculate the antidumping duties, and so I think it could be that there's a symbolic as well as a practical reason why China would be interested in trying to achieve that status.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR BROOKES: Commissioner Wessel.

HEARING COCHAIR WESSEL: Let me answer in part your question as well, since as I recall from press reports there was a significant negotiation between the Brazilians and the Chinese regarding the change in the status to market economy that involved some questions of investments in China, which did not take place subsequent to their decision, as well as the fact that Brazil publicly complained as in the textile and apparel sector, that the result of their action resulted in significant injury to their industry, and they were rather concerned about the failure of the quid pro quo to be effectively administered, shall we say. So I think there are many who think that.

There was also a discussion last year leading up to the potential visit of President Hu here--I believe it was September--of whether, in fact, one or several Chinese sectors might receive the industry sector specific designation as being market oriented. So there has been a lot of history on that.

Let me go back, though, if I could, Dr. Yager, to one clarification. If I remember the criteria that you outlined they are not Commerce developed but they're statutory; are they not? The six or seven--they are statutory; are they not?

DR. YAGER: Let me just take a look. I don't remember that right offhand.

HEARING COCHAIR WESSEL: You can provide that for the record later. That would be fine.

DR. YAGER: Okay. Certainly.

COMMISSIONER REINSCH: I can answer that. They're statutory.

DR. YAGER: They're statutory. Thank you.

HEARING COCHAIR WESSEL: Okay. The question also with regard to Dr. Wortzel's questions earlier regarding proxy issues, that's a subject of significant litigation as well. When a proxy rate is used, the respondent has the opportunity to indicate whether, in fact, it's an effective rate, whether as I believe in the furniture case, they tried to use Russian timber exports as a proxy rate, even though those were subsidized and there were many questions about that.

So the question of what's an effective proxy, if the wrong one is used, the respondent will address that and then that's subject to significant litigation, I believe, in many cases.

My final question or point is with regard to this Commission's activities. China's WTO accession set a time line on market economy status, I believe, of 15 years. At the end of that period, does it automatically change as part of the Accession Agreement? I don't recall and maybe one of the commissioners will recall.

Does it automatically change or is there a review process subject to the statute that's applied at that time?

DR. YAGER: Actually, I don't know if we know the answer to that? I am told that the specific authority in the Accession Agreement expires and they would have to, if we continued on, if the United States continued to use the NME approach, they would have to rely on more general authority provided by the WTO.

HEARING CO-CHAIR WESSEL: So there is no automatic change. We would just change the nexus, the equation by which we evaluate them. Is that?

DR. YAGER: That's what I understand; right.

HEARING COCHAIR WESSEL: Thank you.

HEARING COCHAIR BROOKES: Any other commissioners have questions? That's it. All right. Dr. Yager, than you very much for your time and your testimony and we look forward to more of you good work at GAO.

CHAIRMAN WORTZEL: Thanks a lot.

DR. YAGER: Thank you.

HEARING COCHAIR BROOKES: Without objection, Mr. Chairman, we'll conclude until 12:30; is that correct?

CHAIRMAN WORTZEL: Yes.

HEARING COCHAIR BROOKES: Thank you very much.

[Whereupon, at 11:25 a.m., the hearing recessed, to reconvene at 12:30 p.m., this same day.]

PANEL III: CHINESE ECONOMIC PLANNING AND THE ROLE OF SUBSIDIES

HEARING COCHAIR WESSEL: We'll start the afternoon session and thanks to the witnesses for being here. Our first panel this afternoon will explore the Chinese government's process for planning economic development including the execution of subsidy programs.

We're joined by Usha Haley of the University of New Haven. Dr. Haley's research and teaching interests lie in international business and strategic management. She also consults on strategic management and foreign direct investment for several multinational corporations in North America, Australia, Europe and Asia, and sits on five academic journals' editorial boards.

Her latest books include New Asian Emperors: The Overseas Chinese, Their Strategies and Competitive Advantages, and Multinational Corporations in Political Environments: Ethics, Values and Strategies.

Next we have Dr. Gregory Chow, Professor of Economics, Emeritus, at Princeton University. Dr. Chow served as Chairman of the

American Economic Association's Committee on Exchanges in Economics with the People's Republic of China from 1981 to 1994, and is cochairman of the U.S. Committee on Economics Education and Research in China with support from the Ford Foundation from 1985 to 1994.

He was a member of the U.S.-Hong Kong Economic Cooperation Committee. He advised former prime ministers and chairmen of the Economic Planning and Development Council of the Executive Yuan in Taiwan on economic policy from the mid-1960s to the early 1980s.

Our rules are that if you could present oral testimony from between seven and ten minutes each so that we can also have a good round of questioning from the commissioners, we'd appreciate it. Dr. Haley, if you could begin.

STATEMENT OF DR. USHA C.V. HALEY, DIRECTOR, GLOBAL BUSINESS CENTER, UNIVERSITY OF NEW HAVEN

DR. HALEY: Thank you, Mr. Chairman and members of the Commission for the honor of addressing such a distinguished and thoughtful panel. Unfortunately, I'm a college professor with a big mouth and I don't think I can stay within ten minutes, but I'm going to do my best.

HEARING COCHAIR WESSEL: We will help you.

DR. HALEY: Industrial subsidies in China derive from governmental dominance of the economy and from various factors including the central, provincial and municipal governments, strategy goals, patronage and corruption.

The subsidies include direct and indirect components that affect by the top and bottom lines of industrial operations. My statement stems from research that I have conducted over the last seven years on business in China, some of which has been published in my book, “The Chinese Tao of Business: The Logic of Successful Business Strategy.”

My statement today concentrates on organizational and institutional factors that indicate the presence and effects of subsidies.

Now, this graph indicates that despite the rhetoric, Chinese governmental control over the economy has increased over the last decade. This graph stems from my research and compares China and India's privatization efforts.

In today's testimony, I'm going to first talk about the form and function of Chinese subsidies. Then I'm going to talk about the lack of transparency, what the future holds for subsidies including the PRC's 11th Five Year Plan, recipients of subsidies, and finally the financial performance of our multinational companies.

State subsidies flow into state-owned enterprises, or SOEs, although some well-connected private firms also benefit from indirect subsidies.

Almost all of China's heavy industry and much of its technology lies in governmental hands.

Subsidies exist in all industries that the Chinese state and provincial governments consider economically or strategically important or militarily important.

These subsidies exist in various forms including free to low-cost loans. In three years, from 2002 to 2004, loans increased by 58 percent or $785 billion.

In 2003, new lending equaled almost one-quarter of GDP. Half of all bank loans go to SOEs. Most of these loans will never be repaid.

Asset injections. The SOEs' parent companies, usually municipal governments or ministries, provide their protégés with opportunities to acquire state-run businesses such as toll bridges at highly preferential terms.

No break-even. Poor bookkeeping practices and lax bottom-line considerations grant SOEs freedom from the need to make profits or to break even.

Subsidized purchases. SOEs can purchase their components and raw materials below cost and directly from each other affecting the competitiveness of certain sectors in the global economy.

International bargaining power. Beijing has used its enormous buying power to intercede for its SOEs with foreign suppliers and to reduce acquisition costs for raw materials.

Labor controls. The government exercises various methods to control employees including the dang'an or employment dossier, and to reduce labor costs through injection of part-time and migrant workers and the use of prison labor.

Tax breaks. Many SOEs avoid taxation or reduce it through tax breaks and rebates. Application of China's single-most important revenue source, the Value Added Tax, is also uneven.

China exports or provides VAT rebates for a number of products and offers tax relief often to spur certain exports and encourage FDI in certain sectors.

Multinationals are also encouraged to invest in specific R&D activities in China through tax-based incentives. Common practices use offset deals, which involve the establishment of a laboratory, for example, for joint R&D in key sectors that the Chinese government wishes to cultivate.

Energy and land subsidies. The state subsidizes gasoline and electricity. The state also offers free land and utilities to SOEs and companies in key strategic sectors.

Sectoral credit allocation. The Chinese economy speeds up or slows down on a sector-by-sector basis on credit allocations. Very high levels of bureaucratic interference characterize credit allocations and industrial project approvals in China, and the state banking system does not allow the markets to price capital.

Stock listings. SOEs and collectives form over 93 percent of the listing of approximately 1,300 companies on China's Shanghai and Shenzhen Stock Exchanges.

Provincial governments pressure government regulators to discriminate against private companies and give these precious slots to their ailing state dinosaurs.

Cheap technology. China runs a deficit on its technology trade with the rest of the world and foreign multinationals control 80 percent of technological imports and exports in China.

The Chinese have made little progress in either basic research or advanced design in vital industries despite their rhetoric. SOEs such as Huawei owe much of their success to lax laws governing the theft of intellectual property.

Multinationals have built more than 400 R&D branches in China, and some have complained about de facto coercion by Chinese officials to transfer technology as the price of admission into the Chinese market. One multinational we studied that did so was Microsoft.

Control over distribution channels. Provincial and municipal governments control distribution channels to allocate and to manage market share, to protect favored industries from competition and to shape investment patterns.

Central and provincial governments routinely use legal ambiguity to confer privileges on favored companies or industries and to withhold normal rights from companies or industries as a form of protectionism.

Guanxi with local army officials assumes particular importance for distribution. Some estimates suggest that the People's Liberation Army, of PLA, controls distribution of goods for up to 80 percent of the Chinese population.

Its control over manufacturing facilities also makes the PLA China's largest and most diversified manufacturer of industrial and consumer goods.

Special market information. Relevant information for strategic decisions comes at a premium price in China, and often includes what we in the U.S. would consider insider information. In China, the central government deliberately controls and disseminates information that it considers of strategic importance.

When restrictions on distribution insulate foreign or Chinese companies from their customers, they also cannot undertake direct market research and have to rely on less sophisticated surrogates.

Finally, another subsidy is the undervalued yuan on which I will not be elaborating as there is a distinguished panel talking about that after us.

Lack of transparency, or opacity, as I'm going to call it, has several effects.

It reduces the ability to determine the true efficiency and productivity of China's labor and results in potentially sub-optimal FDI decisions until after commitments are made.

Our research has shown that FDIs enjoy higher ROIs and ROEs across entire industrial sectors in India against China including capital goods; food, beverage and tobacco; materials; pharmaceuticals and biotech; and software and services.

Opacity also reduces the ability of U.S. domestic producers to prove dumping, especially as so many of those affected are small and medium-sized enterprises with limited resources.

It magnifies the weakness of China's statistical system, which depends too much on reporting and too little on sampling. The statistical system shows a systematic bias to over-report growth at the bottom of the economic cycle and underreport it at the top.

Now, some foreign companies have started constructing their own physical activity indices, but the enormous expense constrains companies from really doing this well.

Opacity also reduces the credibility of the SOEs' books. For example, in 2003, China's top 500 SOEs reported revenues of 40.7 trillion yuan, up 25 percent from the previous year, and profits of 334 billion yuan, up 33 percent from the previous year. Only 87 of the 500 reported losses. Unfortunately, most of these SOEs' managers do not know their real profits and tell their supervisors what they want to know.

There are other effects, among them on GDP. Lack of transparency affects our understanding of GDP figures. For example, in February 2002, the Chinese government said that China's GDP had grown 7.3 percent in 2001, making it the world's fastest growing economy.

However, only one of the 31 provinces, Yunnan, said its product had grown slower than the national rate. Taken together, the provincial figures produced a national growth rate nearly two points higher than the official rate.

China's National Statistics Board also lacks the capacity to collect data outside normal information channels and lower level officials interfere with its surveys. The numbers generated by provincial governments remain an important criterion in evaluating local officials' performance, creating an incentive for statistical falsification.

Officials also routinely underreport other sensitive data, such as debt numbers, unemployment or even FDI to avoid tax payments and governmental scrutiny.

The central government's method of ascertaining the validity of data is a process called "yasuo shuifen" -- or squeezing the water. It involves sample surveys, price index adjustments and plenty of guesswork.

HEARING COCHAIR WESSEL: If you can take about two more minutes to sum up. All of your testimony will be submitted for the record, and we want to give ample amount of time for Q&A.

DR. HALEY: The 11th Five Year Program has isolated certain priorities. These include integrated circuits, new generation networks, advanced computing, biomedicine, civil airplane, satellite applications, and new material including high-performance materials in information and biological and aerospace industries. These would be the sectors most likely to receive additional subsidies.

The subsidies are huge. According to a World Bank study, 51 percent of all SOEs are losing money. Average current assets had risen to 319 days of annual sales, suggesting that most of the SOEs' assets lay in uncollectible bills or unsaleable inventory. In short, most SOEs were illiquid and massive injections of government money kept them alive.

What are the policies underpinning subsidies? I'm going to wrap up with this. The policies are political rather than primarily economic considerations, and the considerations that guide them include SOE reforms and strategic goals.

But for the Chinese leadership, SOE reforms do not include concerns about profits or privatization. The reforms do not have as their goal reducing the state's control over key sectors of the economy but rather making the state’s control more effective.

Consequently, the policies aim to make SOEs efficient and big enough to have a strong international presence such as the foreign multinationals do. Specifically, the Chinese government wants its own global stars. The SASAC, which oversees SOEs, has the mandate to transform 20 to 50 SOEs into globally competitive national champions by 2010.

These include the familiar names, PetroChina, ChinaMobile, Sinopec, Baosteel, et cetera.

Some of the policies and subsidies stem from long and mid-range strategic plans. Others derive from emergent planning and mistakes. For example, responding to the massive non-performing loans or NPLs accumulated by Chinese banks in the 1990s, the government ordered that they reduce the NPL ratios. Chinese banks are technically insolvent, but enjoy high liquidity. To cut NPL ratios, the banks merely increase the denominator of the ratios or their loans.

The Asset Management Corporations or AMCs have also become dumping grounds for the NPLs and thereby decrease the ratio. Policies regarding subsidies are very difficult to unravel as the Chinese state encompasses central and local governments with competing and often conflicting agendas and different bureaucratic and political factions at the national and the provincial and the local levels.

Our research has shown that few multinational corporations disclose the real performance of their Chinese operations. Most estimates have relied on business surveys and anecdotes. Our research reveals that only about one-third of the foreign companies operating in China have ever made a profit there. And profits have been concentrated in the hands of a few companies that basically do not face competition from local companies.

Fast foods, for example, do not have technology that is required or that the Chinese government considers strategically important.

In addition, historically, foreign affiliates in China have lower profit margins than their global average. In 2004, the China Economic Quarterly did a survey, and I believe that's the most recent survey of foreign multinational corporations operating in China.

Total China earnings for U.S. foreign affiliates including all sources of profits, licensing and royalties was 8.2 billion dollars. That sounds like a lot, but in 2004, U.S. foreign affiliates earned 7.1 billion dollars in Australia with 19 million people; 8.9 billion in Taiwan and South Korea with 70 million people; and 14.3 billion dollars in Mexico with 95 million people.

Five U.S. companies accounted for one-third of equity profits, including three carmakers, Yum Brands, and McDonalds, which are fast food companies.

Thank you very much.

[The statement follows:]

Prepared statement of Dr. Usha C.V. Haley, Director, Global Business Center, University of New Haven

Thank you, members of the Commission, for the honor of addressing such a distinguished and thoughtful panel. Industrial subsidies in China derive from governmental dominance of the economy and from various factors including the central, provincial and municipal governments' strategic goals, patronage, and corruption. The subsidies include direct and indirect components that affect both the top and bottom lines of industrial operations. My statement stems from research that I have conducted over the last 7 years on business in China, some of which has been published in my book, The Chinese Tao of Business: the Logic of Successful Business Strategy (John Wiley & Sons). Answers to specific concerns follow.

In what form and in what industries do subsidies exist in China?

State subsidies flow into State-Owned Enterprises (SOEs) although some well-connected private firms also benefit from indirect subsidies such as Special Market Information. In 2002, the state controlled half the industrial output and SOEs still account for 35% of urban employment. Almost all of China's heavy industry and much of its technology lies in governmental hands. The government controls about a third of China's economy through SOEs in key sectors such as defense and utilities. The State Owned Assets Supervision and Administration Committee (SASAC) directly manages the top 190 or so SOEs, the biggest of which have international stock-market listings.

Subsidies exist in all industries that the Chinese state and provincial governments considered economically or militarily strategic, including Resource Extraction, Steel, Computing, Software, R & D, Environmental Services and Conservation, and Autos.
The subsidies exist in various forms, including:

A. Free to Low-cost Loans. The government exercises a vice-like grip on banks, stock markets and bond issuance and these translate to the ability to make grandiose loans. The most extreme statistics in the financial sector deal with loans outstanding. In three years from 2002 to 2004, loans increased by 58 per cent, or $785 billion. In 2003, new lending equaled almost one quarter of gross domestic product (GDP). A credit binge fueled this latest boom. Half of all bank loans go to SOEs. Most of these loans will never be repaid. Huawei for example, has a $10 billion credit line from China Development Bank.

B. Asset Injections: The SOEs' parent companies, usually municipal governments or ministries, provide their protégés with opportunities to acquire state-run businesses, such as toll bridges, at highly preferential terms.

C. No Break-even: Poor bookkeeping practices, and lax bottom-line considerations, grant SOEs freedom from the need to make profits, or to break even.

D. Subsidized Purchases: SOEs can purchase their components and raw materials below cost and directly from each other, affecting the competitiveness of certain sectors in the global economy. This tradition propelled the Chinese motorcycle industry's ability to buy control of virtually all Indian motorcycle companies short of Bajaj and turn them into assemblers of Chinese components.

E. International Bargaining Power: Beijing has used its enormous buying power to intercede for its SOEs with foreign suppliers and to reduce acquisition costs for raw materials. A recent example includes the Chinese government's aborted attempt to bully down the cost of iron ore for the Chinese steel industry below internationally-negotiated price levels. The Chinese government has also secured contracts and exploration rights abroad for its SOEs.

F. Labor Controls: The government exercises various methods to control employees including the *dang'an* or employment dossier; and to reduce labor costs through injection of part-time and migrant workers and the use of prison labor.

G. Tax Breaks: Many SOEs avoid taxation or reduce it through tax breaks (although this can backfire if a company's management loses favor).

H. Energy and Land Subsidies: The state subsidizes gasoline and electricity. Currently, Beijing tightly controls the price of both gasoline and electricity at well below their true economic levels. The state also offers free land and utilities to SOEs and companies in key strategic sectors.

I. Sectoral Credit Allocation: The Chinese economy speeds up or slows down on a sector-by-sector basis on credit allocations by Beijing. Some sectors such as automotive, steel, ethylene and metals' smelting have come off the boil. Others sectors such as coal, railways and utilities are still getting huge infusions of policy-mandated credit. Very high levels of bureaucratic interference characterize credit allocations and industrial-project approvals in China and the state banking system does not allow the market to price capital.

J. Stock Listings: SOEs and Collectives form over 93 percent of the listing of approximately 1300 companies on China's Shanghai and Shenzhen Stock Exchanges. Provincial governments pressure government regulators to discriminate against private companies and give the precious slots to their ailing state dinosaurs. Indeed, private companies without state connections cannot obtain a listing on any Chinese stock exchange

K. Cheap Technology: China runs a deficit on its technology trade with the rest of the world and foreign multinational companies control 80 percent of technological imports and exports in China. The Chinese have made little progress in either basic research or advanced design in vital industries. Despite this institutional flaw, SOEs such as Huawei owe much of their success to lax laws governing the theft of intellectual property.

L. Control over Distribution Channels: Provincial and municipal governments control distribution channels to allocate and to manage market share, to protect favored industries from competition and to shape investment patterns. Regulations on distribution incorporate considerable ambiguities leading to both legitimate differences in interpretation and considerable legal efforts to find loopholes. Central and provincial governments routinely use this ambiguity to confer privileges on favored companies or industries, and to withhold normal rights from companies or industries as a form of protectionism. Administrative guidance from various and competing sources can override the basic laws or regulations either explicitly or unofficially. Provincial or municipal governments may interfere with the national limits on distribution by their generosity (to lure investment or to meet local goals) or restrictions (to protect local interests). *Guanxi* with local army officials assumes particular importance for distribution. Some estimates suggest that the Peoples' Liberation Army (PLA) controls distribution of goods for up to about 80 percent of the Chinese population. Its control over manufacturing facilities also makes the PLA China's largest and most diversified manufacturer of industrial and consumer goods.

M. Special Market Information: Relevant information for strategic decisions comes at a premium price in China and often includes what we in the USA would consider Insider Information. In China, the central government deliberately controls and disseminates information that it considers of strategic importance. When restrictions on distribution insulate foreign or Chinese companies from their customers, they also cannot undertake direct market research and have to rely on less-sophisticated surrogates. For example, General Motors' (GMs') interns in Beijing have scoured the capital's streets to find out who is buying their cars after the intermediaries get them, so that GM can build *guanxi* with the buyers.

What complications, if any, in evaluating such subsidies are caused by the lack of transparency in China's government and economic systems?

Lack of transparency affects ability to monitor all forms of subsidy except perhaps Stock Listings. Opacity serves as a tax which

A. Reduces ability to determine the true efficiency and productivity of China's labor and results in potentially sub-optimal foreign direct investment (FDI) decisions until after commitments are made. Consequently, our research has shown that FDI enjoys higher ROIs and ROEs across entire industrial sectors in India against China, including Capital Goods; Food Beverage and Tobacco; Materials; Pharmaceuticals and Biotech; and, Software and Services.
B. Reduces the ability of US domestic producers to prove dumping, especially as so many of those affected are Small and Medium-sized Enterprises with limited resources.
C. Magnifies the weakness of China's statistical system which depends too much on reporting and too little on sampling; the statistical system shows a systematic bias to over-report growth at the bottom of the economic cycle and under-report it at the top, i.e. to flatten out a much more volatile economic cycle. Recently, some foreign companies have started constructing their own physical-activity indices of everything from freight-barge traffic to power consumption and air miles flown to find true economic indicators, but the enormous expense constrains companies from doing this well.
D. Reduces the credibility of the SOEs' books. For example, in 2003, China's top 500 SOEs reported revenues of 4.07 trillion Yuan up 25 percent from the previous year; and profits of 334 billion yuan, up 33 percent from the previous year. Only 87 of the 500 reported making losses. Unfortunately, outright fraud aside, most SOEs' managers do not know their real profits and tell their supervisors what they want to hear

Unreliability in macroeconomic data also seriously compounds the problem of estimating the effects of subsidies.

A. For example, in February 2002, the Chinese government said that China's GDP had grown by 7.3 percent in 2001, making it the world's fastest-growing economy. However, growth rates reported by individual provinces told another story. Only one, Yunnan, said its product had grown slower than the national rate. Taken together, the provincial figures produced a national growth rate nearly two points higher than the official rate! The National Statistics Bureau (NSB) conducts sample surveys and uses these to estimate the country's GDP and growth rate. The results have invariably disagreed with provincial figures. In 1995, the GDP growth rate suggested by provincial data averaged three percentage points higher than the figure of 10.5 percent produced by sample surveys. Opinions vary as regards the accuracy of the central government's estimates. However, in China, few scholars publicly attempt any detailed justification of alternative figures because of political sensitivity.
B. China's NSB also lacks the capacity to collect data outside normal information channels and lower-level officials interfere with its surveys. The numbers generated by provincial governments remain an important criterion in evaluating local officials' performance, creating an incentive for statistical falsification. The pressure to exaggerate statistics grew in the late 1990s as Chinese officials sought to pump up the economy to stave off the Asian economic slump's effects. Beijing declared that the country had to grow at least 7

percent a year to create jobs and to forestall social unrest. Not surprisingly, reported growth rates have not dipped below that level since.

C. Officials may also routinely underreport other sensitive data such as debt numbers, unemployment or even FDI to avoid tax payments and governmental scrutiny. The central government's methods at ascertaining the validity of data, a process it calls *yasuo shuifen* or "squeezing the water", involves sample surveys, price-index adjustments and plenty of guesswork.
D. Technical difficulties, such as staff reductions among statistical analysts, have enhanced errors in data. No comprehensive measures exist for the size of the fast-growing private-business and service sectors or even for what constitutes FDI.
E. The Chinese government strictly controls economic and industrial data and even classifies some as state secrets. Routinely, Beijing has overvalued SOEs' stocks of unsold goods, and underestimated inflation. Other provinces underreport growth and activity: for example, Zhegiang province in Eastern China may have underreported growth to conceal the rapid development of private companies in its economy. Additionally, affluent provinces, such as Guangdong in Southern China, may have underreported growth to avoid paying more taxes to the central government. However, without more systematic data, economists cannot definitively state if these factors pushed up growth or even occurred.
F. Governmental officials downplay unemployment figures to mask the suffering that economic reforms and restructuring have caused. The official unemployment rate of 3.6 percent in 2001 excluded *xiagang* workers (laborers receiving small, monthly stipends from former companies and not counted as unemployed) that economists estimate to number about 10 million. The official rate also excluded farmers who left their fields to work in cities, a floating population of around 150 million unemployed migrants. Using international standards, China's unemployment rate in 2001 approximated 7.6 percent in rural areas and more than 8.5 percent in the cities, well above Beijing's red-flagged figure to indicate inevitable social turmoil.
G. Most disturbingly, the central government's debt numbers look highly erroneous. The Central Bank's governor, Dai Xianlong, confessed to Parliament in April 2002 that national domestic debt appeared much higher than the official numbers (16 percent of GDP) suggested. Dai said the figure appeared closer to 60 percent of GDP if one considered unfunded state-pensions' liabilities, local governments' debts, and major banks' nonperforming loans (NPLs). Dai's unusual candor may mask more bad news. Independent economists have discovered that Dai's statistics drew on China's yearbook GDP growth statistics. Debt more realistically appears closer to 100 or 125 percent of GDP. The Bank of China reported two different figures for its NPLs in 1999, one using Chinese accounting standards, another Western; the latter looms 2.6 times greater than the former. Moody's has openly called the books of China's "Big Four" banks, "meaningless"

What subsidies will be utilized for the 11th Five-Year Program Period?

I anticipate that all the subsidies that I identified will continue. The 11th 5-year plan specifically identifies certain strategically important industries that will receive state subsidies. These include

A. Integrated circuits and software including technology for 90-nanometer and smaller integrated circuits
B. New-generation networks including digital TV networks and mobile communication
C. Advanced computing including technology for petaflop computer systems
D. Biomedicine including commercial production of vaccines
E. Civil airplane including general purpose planes and helicopters
F. Satellite applications including meteorological, oceanographic, navigation positioning and telecommunication satellites
G. New materials including high-performance materials in information biological and aerospace industries

Researchers may have more difficulties monitoring the rate of subsidization as China's 11th Five-Year Plan has only two numeric targets: per capita GDP in 2010 must be double the 2000 figure and "each work unit must cut its use of energy by 20 percent of current levels by 2010". The plan fails to mention raising the price of electricity and gasoline, and unlike the previous ten years, sets no economic growth targets.

How pervasive are subsidies in China?

Our research has shown that despite recent deregulation efforts, state consumption through its SOEs dominates the Chinese economy. Figure 1 indicates difference in state domination of the Indian and Chinese economies. Subsidies permeate SOEs and well-connected private companies but do not extend to the bulk of private companies.

The subsidies appear huge. According to a World Bank study, 51 percent of all SOEs are losing money. Average current assets had risen to 319 days of annual sales, suggesting that most of the SOEs' assets lay in uncollectible bills or unsaleable inventory. In short, most SOEs were illiquid and massive injections of government money kept them alive.

Are they specific to certain industries, or are they broadly available?

The state offers subsidies to specific sectors and across sectors. Generally, SOEs and well-connected private companies with strong government network connections can access subsidies. The state is more likely to offer subsidies to private companies that promote strategic development efforts. The 11th Five-Year Plan identifies the following foci for development:

A. Advanced computing.
B. Internet.
C. Programming.
D. Environmental services & resource conservation.
E. Energy production and reserves.
F. Value-chain positioning of Chinese manufacturing.
G. Space, satellite and space-launch related capabilities.

What policies underlie the subsidies? Are they primarily targeted at companies that export or are they available to companies that serve the domestic market?

The state grants subsidies to companies that export as well as to those that serve the domestic markets. Political rather than primarily economic considerations guide policies on subsidies. For example, many provincial governments offer subsidies as rewards to those that successfully manipulate government and business networks.

SOE reforms and strategic goals also shape policies on subsidies. However, for China's leadership, SOE reforms do not include concerns about profits or privatization. The reforms do not have as their goal reducing the state's control over key sectors of the economy, but rather making that control more effective. Consequently, the policies aim to make SOEs efficient and big enough to have a strong international presence such as the foreign multinational companies do. Specifically, the Chinese government wants its own global stars. The SASAC, which oversees SOEs, has the mandate to transform 30-50 SOEs into globally competitive national champions by 2010. These include PetroChina, ChinaMobile, Sinopec, CNOOC, Baosteel, China Aluminum, Shanghai Auto, Lenovo, TCL, and Quingdao Haier. Korea's chaebol, rather than Japan's keiretsu provide the guiding model for China's policy on industrial subsidies: through subsidies, the state helps the national champions to diversify their range of businesses and to link more closely to the state.

Some of the policies on subsidies stem from long and mid-range strategic plans; others derive from emergent planning and mistakes. For example, responding to the massive NPLs accumulated by Chinese banks in the 1990s, the government ordered they reduce their NPL ratios - bad loans as a proportion of total loans. However, this policy had unintended consequences. China's banks are technically insolvent but enjoy high liquidity. To cut NPL ratios, the banks merely increased the denominator of the ratios: their loans. Lending rose rapidly, driving growth as a side effect as NPL ratios fell from 28 per cent in 2002 to 13.2 percent at the end of 2004. Assisting the process were transfers of old NPLs, made before the recent credit drive, to newly minted asset management companies (AMCs). The largest banks shifted an initial $169 billion in 1999-2000 and another $50 billion last year. The AMCs have become dumping grounds not just for commercial banks' NPLs but also for the assets of failed investment conglomerates, securities businesses and government-infrastructure projects. The state makes the AMCs issue interest-bearing bonds for which it refuses to accept explicit liability. Separately, Beijing has raided tens of billions of dollars of foreign exchange reserves to shore up banks' capital.

Policies regarding subsidies become difficult to unravel as the Chinese state encompasses central and local governments, with competing and often conflicting agendas, and different bureaucratic and political factions at the national level. Subsidies and the policies behind them reflect this fragmentation and conflict. Thousands of warring units that cohabit under the umbrella of the Chinese state control the SOEs. Consequently, SOEs enjoy direct subsidies stemming from state directives and elicit varying degrees of support.

AVIC, the national aerospace group, provides a good example of subsides to an SOE serving a domestic market. Urged by Deng Xiaoping in 1985, AVIC had designed a civil airliner from scratch in less than 5 years. However, it only built two planes and even China's nationalized airlines refused to buy them. Two decades later, AVIC has received several tax breaks to build a small regional jet but has no idea of its commercial prospects

Generally, despite stated policies, outsiders cannot ascertain the true policies that underlie subsidies. A secretive and authoritarian organization with unclear aims, closed to scrutiny and debate, controls the Chinese state. More effectively placed subsidies appear in the SOEs that the Beijing central government has classified as global champions. However, recent examples illustrate their complexity. CNOOC, whose $19 billion bid for Unocal touched off volcanic reactions, is a Hong Kong-listed firm 70 per cent owned by an unlisted parent company, all of whose shares are owned by the central government agency, SASAC. Beijing has helped CNOOC to acquire contracts to control foreign-energy reserves and the company heavily relies on subsidized finance from SASAC. Local governments control other SOEs. These include white goods maker Haier (owned by the Qingdao city government), which launched an unsuccessful bid for Maytag, and the municipally owned Shanghai and Nanjing car companies that have spent the last several months picking through MG Rover. These companies also receive subsidies in line with Beijing's stated goals of creating state-owned multinationals and retaining domestic control over key sectors, such as car making. The demands of both the central government, which sets industry policy, and their local government overlords, whose interests may conflict with Beijing's industrial-policy goals, shape the subsidies the SOEs receive, as well as the SOEs' evolution, strategies and policies. Huawei, a maker of telecoms-network equipment, illustrates a third level of policies and subsidies. Huawei is ostensibly privately owned, although many of its shares are owned by the local state telecoms authorities to whom it has sold equipment. It enjoys a $10 billion low-interest credit line from the China Development Bank, whose mission is to make concessional loans in support of the state's policy goals. Huawei also has strong ties to China's military.

How profitable are companies that serve the China market?

Few multinational corporations disclose the real performance of their Chinese operations. Most estimates have relied instead on business surveys and anecdotes. Our research reveals that only about one-third of the foreign companies operating in China have ever made a profit there, and profits have been concentrated in the hands of a few companies. In addition, historically, foreign affiliates in China have lower profit margins than their global average.

In 1998, a survey of 229 foreign-invested companies by management consultants A. T. Kearney showed that only 38 percent of all manufacturers were covering their operating costs. If the companies had included their borrowing costs, or costs of capital, fewer still could have claimed to have broken even.

Another study done at the Chinese Academy of International Trade and Economic Cooperation showed that about one-third of the 354,000 foreign companies operating in China in 2001 turned a profit. Yet, a 1999 survey by the American Chamber of Commerce in China showed that, while 58 percent of its member companies had lower profit margins there than in other global operations, 88 percent had plans to expand. Deloitte & Touche's survey in 2002 confirmed that 90 percent of foreign-owned companies in China planned to expand their operations within the next three years. In 2003, about 424,196 foreign companies, big and small, operated in China (MOFTEC). Michael Furst, Executive Director of the American Chamber of Commerce, Beijing, informed us that about two-thirds of its member companies were making some profits but not up to anticipated levels, while about one-third were making losses. These figures correspond to those from 2004.

A 2004 survey by China Economic Quarterly shows that the earnings of US affiliates in China, which includes the affiliates' profits, and earnings booked through Hong Kong and Singapore, rose to $4.4 billion. When all other sources of profit are added – including royalty and licensing fees and income from private services – these affiliates earned $8.2 billion in 2004. However, US companies made $7.1 billion in Australia, a market of only 19 million. They earned $8.9 billion in Taiwan and South Korea, emerging economies with a combined population of 70 million and earned $14.3 billion in Mexico. Most respondents could not achieve profit margins above their global average.

A large proportion of the earnings end up with a small number of foreign companies that enjoy lucky breaks in China's heavily regulated operating environment. For example, Mobile Telecommunications encountered no vested interests in China and contributed about half of the US companies' mainland-reported earnings as recently as 2001. However, from 2002, Chinese companies, subsidized by the state, moved into mobile handsets and their cutthroat pricing destroyed profits in that sector.

More recently, a consumer loan boom financed by state-run banks underwrote an explosion in car sales that dropped later like a brick -- but Volkswagen, the market leader, still earned $1.2 billion in China in 2003.

Five US companies, including three car makers, accounted for one third of equity profits that mainland affiliates reported. General Motors alone booked $437 million in earnings. Fast-food companies Yum Brands - owner of KFC - and McDonald's topped off the list. Fast-food companies have consistently made profits in the Chinese domestic economy. They face no competition from state interests and, as services, are less prone to intellectual property abuses. Yum Brands, which has 1,200 restaurants in China, and McDonald's, probably earned about $200 million and the US car companies in excess of $500m - equivalent to about one-third of mainland equity income of $2.4 billion. These figures underline how small China's domestic markets may be.

The exaggerated economic data can have significant effects on perceived performance and projected performance of FDI in China. The successful companies in our research did not rely on economic and industrial data. As Elmar Stachels, Managing Director of Bayer China Company, Ltd., told us "You manage by objectives, objectives that must be clearly stated – then determine what kind of tools you can use to determine if you achieved them, but stick with your objectives. However if it comes to financial figures, it will be challenging. What good will numbers be if the base rates used for comparison of performance are not reliable."

China remains embroiled in overcapacity and excess production as state investment and subsidies move across sectors, and companies' profits correspondingly whipsaw. A year ago in the auto sector, sales growth for many car models dropped from three digits to less than zero in a few months. In steel, China flipped from a massive net importer to a net exporter in less than a year. In the past nine months, the global price of ethylene – a base constituent of plastics – dropped by half as Chinese production capacity expanded 35 per cent this year and will probably double in the next few years. Soon, smelted copper will join the ranks: China has 2.5 million tons of annual production capacity and another 2.5 million tons under construction. Similarly, in stainless steel, China's annual production capacity approximated 2.5 million tons at the end of 2004. Industrial projects and subsidies will expand this to 10 million tons in five years.

Thank you again for having me, and I look forward to your questions.

HEARING COCHAIR WESSEL: Thank you. I apologize for the shortness of time. We want to provide time for a dialogue. Dr. Chow, we will be flexible in our timing. We look forward to your testimony.

STATEMENT OF DR. GREGORY CHOW, PROFESSOR OF ECONOMICS, EMERITUS, PRINCETON UNIVERSITY

DR. CHOW: Well, commissioners, first of all, I don't think you need to worry about my keeping my time. It will not be over the allotted time.

China's WTO compliance, this is the topic of today's testimony page. Now, I will just address the specific questions that were raised to me concisely.

One, the process by which Five Year Plan is established. Each Five Year Plan is proposed by the State Council to the National People's Congress for enactment as law. The preparation of the proposed plan is the responsibility of the Commission for Economic Development and Reform in the State Council.

Second, which established benchmarks of the 9th and the 10th Five Year Plans were met and which not?

Targets for growth of national output, urban and rural income and rate of inflation have been met because they were conservative. Plans to solve social problems such as rural poverty, income disparity, and establish a social welfare system progressed more slowly than intended.

Components of the 11th Five Year Plan. Now, I draw the material from two articles in the official Chinese newspaper, "People's Daily Online," which I read every day, so there are two articles which have seven plus seven, 14 components in the plan.

These are the 14 components. Establish main targets of economic and social development. Build a new socialist countryside. Actually, this is the reform for the farmers, to help the farmers in rural areas. Adjust and upgrade industrial structure in which some components deal with subsidies. Speed up service industry development. Promote balanced regional development. Build a resource-efficient and environment-friendly society.

Next, promote science and education. Next page. Deepen system reform. Now this item is in every Five Year Plan because China started so-called system reform toward market economies so every time in the last 20 some year, they always say deepen reform.

Implement mutually beneficial open-door policy. Right. That's another standard item of China's reform--open door policy.

Build a harmonious socialist society. Construct socialist, democratic democracy and politics. Now, the word "democracy" has to be understood in Chinese terms.

Strengthening construction of socialist culture. Strengthening construction of national defense and the military. Establishing and improving implementation mechanism.

I want to mention one thing. That is about democracy. People have been talking about China's lack of democracy. I think some of the criticism is justified, but I wanted to point out that if you look at the last several Five Year Plans, and if you look at the annual reports of the prime minister to the People's Congress, every time there's an emphasis on the topic of promoting democracy, you should look at the content and see what they are talking about.

How goals are to be accomplished? GDP goals and inflation targets are set conservatively. Economic forces will accomplish them with little government effort.

Now one of my major observations about the Chinese economy is that China has been successful not because of government planning. It's the ingenuity of the Chinese people. And the government provides an environment, set of market institutions in which the Chinese ingenuity in entrepreneurship and the skillful Chinese laborers can function. So that China has been able to grow so rapidly for over 25 years, mainly because of the people there in spite of the imperfect market institutions.

Second, other goals are less specific and individual ministries in the State Council have responsibility to accomplish them. For example, one item, to establish a new socialist whatever countryside, as they want to help the poor rural people to get richer, and the specific program, or part of the program is done by the Ministry of Agriculture.

Four, which industries do subsidies exist? Now, high tech is one because China wants more high tech. In fact, I think China has been quite successful in upgrading China's high tech -- I think the improvement of China's high tech is phenomenal. Of course, it's still behind the U.S., but it's phenomenal.

Agricultural production. They want to improve the living standards of farmers. And clean energy production. Now, I think Professor Haley mentioned this point, too. Foreign invested industries get help from the Chinese government. Chinese government wants to encourage foreign investment, so they give you foreign investors a lower tax rate or supply them with inexpensive land.

For a more concrete list, one can consult the document of the 11th Five Year Plan itself, which is several hundred pages long. Now, I don't have a copy of that document because the plan just came out, but I did look at the 10th Five Year Plan quite carefully before.

I don't think a copy is available now, unless you ask your Chinese friends to send you FedEx because the document was just passed Congress, and you may have a look at it.

4(b) lack of transparency and use of subsidies to implement 11th Five Year plan. In my opinion, essentially there is no lack of transparency to prevent evaluation of subsidies. I have studied the Chinese economy for more than 25 years, and I always find out what things are going by using official sources.

I should refer to my book, “China's Economic Transformation,” and you can see from my book how much material there is that I have obtained from the official sources. Most targets of the Five Year Plan do not require subsidies as we are talking about the Five Year Plan and industrial subsidies. But most parts of the Five Year Plan are not about industrial subsidies.

They are about the 14 items that I've mentioned. So subsidies are a very, very trivial part of the Five Year Plan, and the other partsdo not require subsidies to implement. Subsidies are only very small part of the Five Year Plan.

Now, I'd like to quote from my other book, "Knowing China," which has a section on U.S.-China economic competition. Since China has high quality and low cost labor, many manufacturing firms from the U.S. and other developed economies have moved and are moving to China.

This decreases the demand for the services from similar workers in the United States and would tend to lower their wages and reduce the employment of such workers in the United States. This tendency is unavoidable.

The solution to be achieved by market forces is for the United States to shift its production from such manufacturing industries to some selected high tech industries or service industries that the United States is better suited to develop than China.

Another quotation: "Other things being equal, moving one factory from the U.S. to take advantage of the low cost labor in China will lead to a higher national income for the United States as a whole, but lower employment and lower wage for the workers. When physical capital is moved with the factory to a China, there will be less capital and hence reduced total output in the U.S. But the capital that is moved will earn more in China to compensate for the loss."

So as a result, there's a net gain. This would lead to a net increase in the U.S. GNP.

Next quote: "China's economic expansion has several favorable effects for the U.S. First, China provides investment opportunities for U.S. investors. U.S. corporations setting up factories in China can increase their profits, which are good for their stockholders and for raising total national income.

"Second, China provides a large market for goods produced in the U.S. and helps to increase employment in the industries producing such goods.

"Third, China produces a large number of inexpensive and high quality consumer goods being exported to the U.S. to benefit the American consumers. Economic cooperation with China is therefore beneficial to the U.S. and China as well."

HEARING COCHAIR WESSEL: If you could sum up?

DR. CHOW: Yes, I will conclude. U.S. interests can better be served by promoting economic cooperation with China in the course of economic globalization rather than finding faults in China's compliance with the terms of the WTO in order to justify imposing higher tariffs on Chinese products.

The latter action will not be effective in reducing competition from China, the strength of which is based on economic fundamentals like high quality and inexpensive labor rather than artificial industrial subsidies.

It will do economic harm to the U.S. in stifling innovation and in preventing the natural healthy development of the U.S. economy in taking its rightful place in the world economic community.

Quote from the editorial of the New York Times, March 27:

"The Schumer-Graham bill is based on a fundamental misunderstanding of the root cause of America's economic problems. No question. The U.S. trade deficit and the loss of American manufacturing jobs are very serious. But most of the imbalance with China is caused by America's insatiable appetite for Chinese imports for which there are few domestic substitutes. While it is unfortunate that the textile industry has all but faded away in this country, the fact is that few American factories make things like low priced apparel any longer."

Thank you very much.

[The statement follows:]

Prepared statement of Dr. Gregory Chow, Professor of Economics, Emeritus, Princeton University

1. What is the process by which the Chinese leadership establishes each Five Year Plan for the Chinese economy?

Each Five-Year Plan is proposed by the State Council to the National People's Congress for enactment as law. The preparation of the proposed Plan is the responsibility of the Commission for Economic Development and Reform in the State Council.

2. Which established benchmarks of the 9th and 10th Five-Year Plans did China meet and which, if any, of these Plan's goals were not achieved?

The most important goal is the rate of growth of real GDP. In both the 9th and 10th Five-year Plan the actual rate of growth turned out to exceed the rate stated in the Plan.

3. What components are included in or being considered for China's 11th Five-Year Program? How has the Chinese government stated, and how do you believe, it will act to accomplish the economic goals it sets for itself?

The following two articles in the *People's Daily Online* on March 21-2 2006 state the major components included in China's Eleventh Five-Year Plan:

Abstract of the Eleventh Five-Year Plan outline (draft) -1

(updated March 8, 2006)

The State Council has submitted the draft outline of the 11th Five-Year Plan for national economic and social development to the fourth session of the 10th National People's Congress for deliberation.

The outline was drafted according to CPC Central Committee proposal on the 11th Five-Year Plan for national economic and social development. Drawn to clarify national strategic intention, identify government work emphasis and guide market behavior, it is a grand blueprint for China's economic and social development in the next five years.

It is the common action guidelines for all ethnic groups in China as well as the important basis for the government to carry out economic regulation, market supervision, social administration and public service.

The draft outline comprises 48 chapters in 14 articles.

Main targets of economic and social development

The draft outline has set forth main targets of economic and social development in the next five years.

- Smooth and steady operation of the macro-economy. Gross Domestic Product is to grow 7.5 percent annually to double the per capita GDP in 2000. Both urban employment and migrant agricultural laborers will increase 45 million. Registered urban unemployment will remain under 5 percent.

- Optimizing and upgrading industrial structure. Proportion of added value in service industry to GDP and that of new employment to total employment will grow by 3 and 4 percentage points respectively. R&D expenditure will increase to 2 percent of GDP.

- Considerably improving efficiency of resource use. Energy consumption per unit of GDP is to decrease by 20 percent. Water consumption per unit of industrial added value is to decline by 30 percent. Irrigation water use efficiency is to increase by 0.5. Industrial solid waste recycling and conserving rate is to grow 60 percent.

- Urban and rural development is to grow balanced with urbanization rate growing to 47 percent.

- Basic public service is to be greatly reinforced. People's average education is to increase to 9 years. Urban basic endowment insurance is to cover 223 million people. New rural cooperative medical care's coverage will reach over 80 percent.

- Sustainable development capacity will be boosted. The total population will be controlled under 1.36 billion. Arable land will be maintained at 120 million hectares. Main pollutant discharges will be reduced by 10 percent and forest coverage will reach 20 percent.

- Relatively complete market economic system

- People's living standard continues to improve. Urban resident per capita disposable income and rural resident per capita net income will grow by an annual rate of 5 percent respectively.

- Democratic and legal system construction and spiritual civilization construction will make new progress.

Building a new socialist countryside

The draft outline proposes to continue the basic strategy of overall planning of urban and rural economic and social development. While actively promoting urbanization, solid and steady progress will be made in building a new socialist countryside according to the requirement of advanced production, improved livelihood, a civilized social atmosphere, clean and tidy villages and democratic administration.

It proposes to stick to developing agricultural productivity as the primary task of building a new socialist countryside, maintaining grain production growth and increasing its production capability to around 500 million tons.

It also proposes to extend agricultural industrial chain to let farmers benefit more from the expansion of agricultural functions and develop farm produce processing, freshness preservation, storage, transportation and other services.

It suggests to accelerate implementation of rural water safety project, basically realize connection of all towns by asphalt (cement) roads, perfect rural power grid, basically connect all the villages with telephones and provide internet access in every town, complete rural healthcare and medical aid system, emphasize popularization and consolidation of nine-year compulsory education in rural areas and eliminate tuition and incidental fees for rural students during the compulsory education period.

The draft outline proposes to stick to the guideline of "giving more, taking less and being flexible" and speed up the construction of a long-term mechanism in promoting agriculture by industry and towns by cities.

Boosting optimization and upgrade of industrial structure

The draft outline proposes to adjust and optimize industrial structure, corporate structuring and industrial arrangement with increasing independent innovation as the core link so as to increase overall technological level and improve competitiveness of industry.

It requires the extension of high-tech industries from processing and assembling to independent research and development and advancement of independent innovation commercialization; a series of leading industries with core competence should be formed; a group of industrial bases with concentration effect and a batch of transnational high-tech companies should be established and a raft of brand names of proprietary rights should be raised.

The outline proposes to make breakthrough in core technologies, increase the level of development and design of key technologies and equipment, localization of core components, the manufacture and system integration. A stable, economical, clean and safe energy supply system must be built.

Speeding up service industry development

The draft outline insists on marketization, industrialization and socialization; scope expansion, scale increase, structure optimization, function reinforcement, market standardization and raising the proportion and level of service industry.

It proposes to add 17,000 kilometers of railway, of which passenger lines account for 7,000 kilometers; to increase total length of highway to 2.3 million kilometers, of which expressways account for 65,000 kilometers; to build Yangtze waterway and high-level navigation course networks in the Yangtze River Delta and Pearl River Delta etc.; to build international shipping centers in Shanghai, Tianjin and Dalian etc.

Promoting balanced regional development

The outline proposes to boost balanced regional development to gradually form development arrangement that has clear function positioning, virtuous interaction among the eastern, central and western regions, and narrows gap in public service and people's living standards.

The overall strategy for regional development the outline puts forward is advancing the western development, rejuvenating old industrial bases in northeast China, promoting the rise of the central region; and encouraging development of the east first.

It proposes to give overall planning to population distribution, economic deployment, land utilization and urbanization pattern in light of the carrying capacity of resources and environment, existing development density and potential, so as to classify the land space into four categories: optimized development, key development, restricted and banned development zones.

By People's Daily Online

Abstract of the Eleventh Five-Year Plan outline (draft) -2

Building a resource-efficient and environment-friendly society

The draft outline proposes to implement the basic national policy of saving resources and protecting environment, building a circular and sustainable national economic system and a resource-efficient and environment-friendly society with low investment, low consumption and low discharge while achieving high output.

The outline emphasizes that urban sewage treatment rate will not be lower than 70 percent by 2010 and urban refuse decontamination rate not lower than 60 percent.

The outline requires improvement of water use license and water resource compensation system, establishment of state initial water right distribution system and water right transfer system. Land use approval and compensation system should be strictly implemented and mining-resource use compensation system, mine environment reclamation and compensation mechanism, and key resource reserve system should be improved.

Rejuvenating the country through science and education and strengthening the nation with talent

The outline suggests to implement the strategies of rejuvenating the country through science and education and strengthening the nation with talented people, making scientific and technological advancement and innovation an important driving force for economic and social development, putting education and training of quality talents at a prominent strategic position while striving to build an innovative country with rich human resources.

The outline emphasizes more education investment by ensuring higher financial expenditure for education so as to gradually increase the proportion of financial expenditure for education in GDP to 4 percent.

Deepening system reform

The outline proposes to deepen system reform, emphasizing transformation of government function and reform of enterprises, financial and taxation and banking; improve socialist system of market economy to form a mechanism that favors transformation of economic growth mode and pushes forward comprehensive, balanced and sustainable development.

The outline emphasizes reform of administrative system. A system of scientific decision-making, corresponding rights and responsibilities, reasonable responsibility, smooth execution and effective supervision will be established according to the principle of simplicity, unity and efficiency.

Deepen reform of state-owned enterprises, concentrate state-owned assets into key sectors and areas that concern the national security and economic life lines.

Promote reform of financial and taxation system, demarcate responsibility of financial expenditure of governments at various levels and reasonably adjust financial revenue allocation among governments.

Speed up the financial system reform, actively boost reform of state-owned commercial banks and reasonably define policy-based bank functions.

Accelerate development of direct financing, perfect financial regulatory mechanism and improve financial supervision system.

Implementing mutually beneficial and win-win opening up strategy

The outline proposes to implement mutually beneficial and win-win opening up strategy, insist on the basic national policy of opening up to participate in international economic and technological cooperation and competition in a larger scope, broader areas and at a higher level, better promote domestic development and reform and earnestly protect national economic security.

The outline proposes to swiftly change foreign trade growth mode, shifting from quantitative to qualitative growth. Trade in goods and service will reach \$2.3 trillion and \$400 billion respectively by 2010. It emphasizes improving the quality of foreign investment utilization through introducing advanced foreign technologies, management expertise and talents with foreign investment. It requires active international economic cooperation, especially economic and technological cooperation with neighboring countries to realize mutual benefit and win-win situation.

Building a harmonious socialist society

The draft outline points out that a harmonious society should be promoted on the principle of democratic rule of law, equity and justice, honest and friendliness, vitality, orderliness and harmonious coexistence, and by starting with the most direct and practical issues that concern the interests of the masses.

The outline emphasizes implementation of active employment policy, overall planning of urban and rural employment and striving to control the jobless scale.

Improve employment support system for disadvantaged regions, sectors and groups. Expand urban basic endowment insurance coverage and improve subsistence allowances system for the urban poor.

The outline emphasizes improving healthcare for the public, conscientiously solve the problems of difficult and expensive access to medical care for the public.

Deepen reform of medical care system and strengthen supervision of medical service behavior, quality and the medicine market; reduce excessively high medicine price and contain the hike of medical expenses.

Reinforcing construction of socialist democracy and politics

The draft outline proposes to reinforce construction of socialist democracy and politics, insist on an all-round development of political and material civilization, expand socialist democracy, improve legal system and provide political guarantee for the modernization construction.

The outline emphasizes insistence on and perfecting the people's congress system, the CPC (Communist Party of China)-led multi-party cooperation and political consultation system and the ethnic regional autonomy system, actively and steadily advancing reform of political system, consolidating the political situation characterized by democracy, solidarity, liveliness, stability and harmony.

Strengthening construction of socialist culture

The draft outline proposes to firmly control the direction of advanced culture in serving the people, serving socialism as well as letting a hundred flowers blossom and a hundred schools of thought contend so as to prosper the socialist culture and meet people's increasing demand for culture.

The outline emphasizes increase of government investment in cultural undertaking to gradually form a relatively complete public cultural service system that covers the whole society.

Continue to deepen reform of cultural system by setting up a self-regulated cultural management system and a vital cultural product producing and operating mechanism, led by Party committee leaders, managed by the government, operated by corporate and society with self-discipline and according to law,

Strengthening construction of national defense and the military

The draft outline proposes to strengthen construction of national defense and military modernization according to the requirement of safeguarding national security and unity and the development needs to create a good situation in which national defense and economic constructions are coordinated.

The outline requires to strengthen construction of a revolutionary, modernized and regularized military in an all-round way in order to effectively carry out historic mission in the new phase of the new century, actively promote military reform with Chinese characteristics and strive to raise the overall defense and combat capability of the military in the information era.

Establishing and improving implementation mechanism

The draft outline proposes to rely on the fundamental role of the market in resource allocation to realize the targets and tasks outlined in this plan under the circumstance that a socialist market system has been preliminarily formed. In the meantime, the government should properly deliver its duty by regulating and guiding social resources, reasonably allocating public resources and ensuring the smooth implementation of the plan.

By People's Daily Online

Most of the economic targets such as for GDP growth and inflation rate in the 11th Five-Year Plan do not require the government to do much because the Chinese economy will grow in its own way with or without the plan. The purpose of having a Five-Year Plan today is not the same as during the period of central planning, before economic reform started in 1978 towards a market economy, when output targets were set and the state enterprises produced according to the targets. Today output and prices are driven mainly by the market forces to large extent, with producers, including those enterprises with shares owned mainly be the state, determining their own outputs to maximize profits or other economic objectives of their own. The main purposes of the Five-Year Plan are to specify programs for developing China's economic and social infrastructure and social welfare programs, and to promote social development in general, including environmental protection, education and democracy (as the government understands it}, as one can read from the outline of the 11th Five-Year Plan given above. The government will implement its program by giving various ministries of the State Council responsibility for the specific parts of the program. Some programs such as compulsory education will be carried out by local governments.

Note that the planned rates of growth of real GDP (8 percent for 2006, and 7.5 percent annually for the five years up tot 2010) will be easily exceeded given the current rate of over 9 percent per year in the last few years. The per capita disposable income of urban residents and the per capita net income of rural residents will grow at an average annual rate of five percent respectively according to the Plan whereas they have grown at about 7.5 and 5.5 percent per year during the previous fourteen years. One reason for selecting a lower rate is to reduce the probability of failure. Another reason is to slow down the growth because some government officials consider the current rate excessive. However we can expect the actual rate to turn out higher than planned.

4. In what form and in which industries do subsidies exist in China? What complications, if any, in evaluating such subsidies are caused by lack of transparency in China's government and economic system? What subsidies do you anticipate will be utilized to execute the goals of the 11th Five-Year Program?

For the first part of the question one can read the 11th Five-Year Plan itself which is several hundred pages long but high tech industries, agriculture, clean energy production and foreign invested industries are among them. There is no lack of transparencies. The Chinese government makes clear to the public and to the world what industries they want to subsidize. The execution of the 11th Five Year Plan, as can be seen by the list of its components, depends to only a limited extent on industrial subsidies. If one is concerned with subsidies under the definition of WTO that may hurt US economic interest, one should note, first, that only "specific subsidies" which benefit specific firms or industries are under the provision of WTO, and, second, competition from imports produced in China is hardly dependent on specific subsidies but mainly on the abundance of high-quality labor force in China, making the labor cost of production low (for US firms producing in China for export also).

In my book, *Knowing China* (World Scientific, 2002, pp. 225-6) I observe the economic competition between the US and China as follows:

"Since China has high-quality and low-cost labor, many manufacturing firms from the United States and other developed economies have moved, and are moving, to China. This decreases the demand for the services from similar workers in the United States and would tend to lower their wages and reduce the employment of such workers in the United States. This tendency is unavoidable. The solution, to be achieved by market forces, is for the United States to shift its production from such manufacturing industries to some selected high-tech industries or service industries that the United States is better suited to develop than China. Historically such shifts in production have occurred in the United States [including the shift in the production of textiles from New England to the South] to prevent the overall rate of unemployment to increase in the long run. In the short run, however, the workers displaced, some of whom are suffering a great deal, had to face painful adjustment problems.

"Other things being equal, moving one factory from the United States to take advantage of the low-cost labor in China will lead to a higher national income for the United States as a whole but a lower employment and lower wage for the workers. When physical capital is moved with the factory to China, there will be less capital and hence reduced total output in United States. But the capital that is moved will earn more in China to compensate for the loss of output in the United States, otherwise the move will not be made. This leads to a net increase in the US national income. As factories are moved to China, while the United States gains in total national income or output, wages and employment of the workers in these and similar factories in the United States will be reduced. The people, including workers, owning stocks of the companies that move their factories to China will gain.

"In the above analysis I have not considered other things that may happen. Competition from low-cost labor in China will provide incentives for US workers to improve their skills to find new jobs and for US entrepreneurs to develop new products or services to employ the labor now available. This is a part of the economic globalization process. I have discussed its impact on China in providing foreign competition to the Chinese state-enterprises and commercial banks as China has become a member of the WTO. The United States has an abundance of capital relative to labor, while China has an abundance of labor relative to capital. As capital moves from the United States to China, it will lower the return to capital in China and lower the wage rate in the United States, but it will raise the wage of the Chinese workers and raise the return to American capital. Both economies will have to find adjustments to weather the impact. In the long run both countries will be better off as their national incomes will increase at a faster rate as a result of economic globalization.

"China's economic expansion has several favorable effects for the United States. First, as we have just pointed out, China provides investment opportunities for US investors. US corporations setting up factories in China can increase their profits which are good for their stockholders and for raising total national income. Second, China provides a large market for goods produced in the United States and helps to increase employment in the industries producing such goods. Third, China produces a large number of inexpensive and high-quality consumer goods being exported to the United States to benefit the American consumers. Economic cooperation with China is therefore beneficial to the United States and to China as well."

On the basis of the above analysis, one can conclude that US interests can be better served by promoting economic cooperation with China in the course of economic globalization rather than finding faults in China's compliance with the terms of the WTO in order to justify imposing higher tariffs on Chinese products. The latter action will not be effective in reducing competition from China, the strength of which is based on economic fundamentals rather than artificial industrial subsidies; it will do economic harm to the US in stifling innovation and in preventing the natural healthy development of the US economy in taking its rightful place in the world economic community.

In closing I would like to quote from the editorial entitled "Mr. Schumer Goes to China" on the March 27 issue of *New York Times* (p. A18): "At the end of a fact-finding trip last week, Mr. Schumer told reporters that he was no longer sure he would for a vote to impose tariffs on Chinese imports into the United States.. and "we [including Senator Lindsey Graham] are more optimistic that this can be worked out than we were in the past.

"Maybe the chance to talk face-to-face with Chinese on their own home turf is what it took to make Mr. Graham and Mr. Schumer realize that just as trade is a two-way street, so too are sanctions. If lawmakers actually went ahead with the Shumer-Graham bill, which would impose 27.5 percent tariffs – a staggering amount – on Chinese goods, they would be accomplishing little to cut American unemployment, while hurting poor Americans who rely on inexpensive goods and poor Chinese whose livelihoods depend on making those products.

"The Schumer-Graham bill is based on a fundamental misunderstanding of the root cause of America's economic problems. No question, the United States trade deficit and the loss of American manufacturing jobs are very serious. But most of the imbalance with China is caused by Americans' insatiable appetite for Chinese imports for which there are few domestic substitutes. While it is unfortunate that the textile industry has all but faded away in this country, the fact is that few American factories make things like low priced apparel any longer."

PANEL III: Discussion, Questions and Answers

HEARING COCHAIR WESSEL: Thank you both and thank you for the thoroughness of your prepared testimony as well as your oral remarks. As I said, they will be submitted for the record. In preparing for this hearing, we of course did a fairly wide survey of these issues and both of your work stood out as being important additions to our dialogue here and thank you for that.

There were not too many that stood out as part of this overall debate, and your help and your work is very much appreciated.

First question goes to Commissioner Reinsch.

COMMISSIONER REINSCH: I've got a couple of questions for Dr. Haley.

I was interested in the list of subsidies that you have. Did you or can you make a distinction between which of those subsidies are WTO prohibited and which are not?

DR. HALEY: No, because there isn't really enough information. For example, how do I tell you what's "break even" when these SOEs keep two sets of books for the most part, at least two. Generally they have about three.

Similarly on labor controls, the dang'an is never released, not even to the person in question. That's an employment file that even the employee never sees their entire life. It's a method of control.

COMMISSIONER REINSCH: Sure. I understand that. I guess what I'm getting at is if from a perspective of when the United States is going to take some action. We have to draw the line somewhere, and I think we have to make some judgments as to what is a subsidy within the commonly accepted meaning of the term, and what is simply the way they choose to organize their economy.

DR. HALEY: I'm going to have to give that some thought really because I really would like to go through this more carefully and look at the data that are available and--

COMMISSIONER REINSCH: Okay. I appreciate that. Dr. Chow, do you have a comment on that before I go--

DR. CHOW: Yes. May I respond to that question? Actually, I looked over the terms of WTO. If you look at the WTO terms for subsidies, they have to be specific subsidies because when I was asked to come down and some people said, well, China undervalues its currency, so many things from China are cheap. Everything is cheap; right. But that doesn't count. Undervaluation of the RMB cannot count as subsidies in WTO terms. I have a paper on the Chinese RMB exchange rate, which I will submit for your consideration.

But that doesn't count at all. Because there are no specific subsidies. So you have to either look at the WTO terms specifically, things have to be very specific in order for the terms to apply.

COMMISSIONER REINSCH: Well, thank you for that. That's a good point. Some of the items on Dr. Haley's list I think clearly are specific; some are not. That's one reason why I asked the question.

Let me pursue that a little bit more with another question. Looking at the list of recipients, if you will, recipient industries or sectors for the subsidies, a lot of them seem to be, high tech, cutting edge sectors, biomedicine, satellites, stem cell research. I assume this is research subsidies primarily.

DR. HALEY: Yes, currently they are. They weren't always, but currently they are.

COMMISSIONER REINSCH: Sure. Now, are those SOEs that are conducting that research?

DR. HALEY: Primarily. I do agree with Professor Chow that the Chinese are entrepreneurial, the Chinese are innovative, and the Chinese people have enormous potential. I do not believe that the private sector in China has been given a chance, and for the most part, you have to be very well connected with the government in order to even get yourself listed on the stock exchanges or to get government support.

For our book, “The Chinese Tao”, we interviewed I guess the who's who of China, and we spent a lot of time talking to them. We spent days talking to each one of them, people like Pan Shi Yi, the largest developer in Beijing, who has put up the World Trade Center, Li Ka-shing, Chairman of Hutchison Whampoa, et cetera. Again and again, this came out, that you have to have your goals synchronize with those of the government, implicitly or explicitly. So I do not believe that you really can come up in that economy if you don't have close government connections with the government.

COMMISSIONER REINSCH: Okay. Dr. Chow first, and I want to come back to that.

DR. CHOW: The truth is the following: of course, if you want to do business in China, you need guanxi (connections), right. That's in my book.

But on the other hand, the initiative of the Chinese people without any government connections, they are responsible for the most successful part of the Chinese economy because if you're a smart person, you always get your guanxi, right. If you have a good idea, you can sell it to the government officials to approve it, so you have to establish guanxi. You need that. But this is the Chinese system, right.

But if you look at all the rich people that have come out, most were nobodies. They had no connections before, and because they were smart, I can give you the whole list. So that if you look at the history of most of the successful people, they started with nothing. But of course, they established guanxi in the course of time.

COMMISSIONER REINSCH: Let's come back to where I was going with this, if I can just conclude. Have either of you figured out or have an estimate of how much Chinese GDP comes from the private sector and how much comes from the SOEs?

DR. CHOW: Oh, I have this in my book, even several years ago.

COMMISSIONER REINSCH: Well, what's the answer?

DR. CHOW: I heard that. As early as 1996, only about 28 percent of the industrial output in China was produced by state-owned enterprises. China has a big section of collective enterprises.

COMMISSIONER REINSCH: Do you have a number that's more recent than 1996?

DR. CHOW: Probably less, because that would demonstrate that the fraction of Chinese GDP contributed by the government part has been reducing through the years. I could easily look it up for you. But I just quote it--

COMMISSIONER REINSCH: Let me ask Dr. Haley if she has the same number?

DR. HALEY: I'd love to sound really knowledgeable, but the Chinese government doesn't even have a proper definition of what constitutes the private sector or the services sector which we now estimate are the fastest growing parts of the economy.

HEARING COCHAIR WESSEL: Chairman Wortzel.

CHAIRMAN WORTZEL: I want to thank both of you for being here and for your remarks today. Dr. Haley, as I look through one of your articles, you expressed concern that one-third of American companies are losing money in China?

DR. HALEY: Well, no, I said one-third are making money in China.

CHAIRMAN WORTZEL: Are making money.

DR. HALEY: Yes.

CHAIRMAN WORTZEL: So two-thirds are losing money?

DR. HALEY: Yes.

CHAIRMAN WORTZEL: Why should that be the concern of the Congress of the United States if a private American company chooses to diversify its investments but it loses money in China? I agree it should be a stockholder concern. I agree that it should probably be a board of directors or trustees' concern, but not a government concern.

Also, it would be helpful if you could tell us what technology or exports are going to China that erode the national security of the United States or improve the military capacity of China as a consequence of these specific subsidies?

DR. HALEY: Well, I don't even think the companies would release that kind of information. What concerns me in a broader sense, though, is the sort of technologies that are going. I'm not an expert on R&D and the return on investment for R&D, but I can tell you that you do have to put in a lot of bucks before you get the bang.

That is there isn't a direct correlation between the amount of money you put in and the results that you want, so it's a long and tedious process. It takes a lot of investment and a lot of effort and eventually that is a core competence for our companies. We've lost our core competence in lower-end manufacturing. We really cannot compete on labor for various reasons, fair and unfair. We do and can compete on technology--that is on the higher end technology.

We have the institutional fabric including a very good higher educational system, the best in the world, a free press, the ability to create and wait for results. None of these institutional factors exist in China, so despite the fact that the Chinese government puts in 1.2 percent of its GDP into R&D and it wants to double this to two percent or so, and it's planning on catching up with the United States in about a decade or so the amount of investment, I do not think that China can ever compete on a fair and level playing ground with the United States, not under its present system of government, when you have, for example, 160,000 people who are just basically eyeballing the Internet.

That degree of control stifles innovation. It stifles creativity. China does not have an environment in which you can come up with new knowledge, and its companies need it, they need it in order to compete. They need it to move up the higher value-added chain. The sectors that the government has identified, and that Professor Chow brought up and that I brought up, are the ones in which they're interested. They're fairly open about that currently.

Their interests lie in dual-purpose technologies. That is the technologies have both military as well as civilian uses. Some of the technologies deal with renewable energy services. You just need to make a trip to Beijing to see its potential application. It's difficult to breathe there on some days, but there are a whole host of other ways in which the technologies can be used.

I work with a lot of these American companies in China. In some sense, greed propels them. They see the Chinese market. They see the potential. They go there. They establish themselves. They start producing. Sometimes they have no choice. The Chinese government puts down technology transfer as a condition. You can't get in unless you give up your technology. You can't get it unless you get into a joint venture with a local partner.

Then these American companies' core competence gets hit--that core competence that they put a lot of money and time into and effort into, and it's gone.

The Chinese companies we found are very weak in brand name, research and development, organizational and managerial skills, and those are the kinds of investments and joint ventures that the Chinese government is looking for. It's looking to complement the Chinese companies' weaknesses.

DR. CHOW: Do I understand the question to be the U.S. attitude toward China buying things from the U.S.? Is that the question?

CHAIRMAN WORTZEL: If American companies, two-thirds of them are not profitable in China, they're losing money.

DR. CHOW: Oh, American company in China not making money; okay.

CHAIRMAN WORTZEL: That's a corporate decision.

DR. CHOW: Yes, sure.

CHAIRMAN WORTZEL: If I own stock in a company, I ought to care.

DR. CHOW: Yes, yes, right.

CHAIRMAN WORTZEL: If I don't, let some other investor worry about it.

DR. CHOW: Yes.

CHAIRMAN WORTZEL: But from a national security standpoint, is there some flow of specific technologies that improve the Chinese military when these companies are still losing money over there? That's what I care about.

DR. CHOW: Oh, let me ask you this. If the companies were making money, would you be still asking the same question?

CHAIRMAN WORTZEL: Sure.

DR. CHOW: So that's my point. Whether the companies are making money or not, that's not the issue. The issue is that when the companies go over there, they might give China some technology and we may be concerned about that. That's the question.

Now, about this kind of thing, I think that there are pros and cons. I don't have a definite opinion. I can appreciate the legitimate concern when, for example, China wants to buy an American oil company when this would affect American dominance in controlling the oil resources, I can see the U.S. being concerned. Another example would be the U.S. has decided not to let China buy some high tech computers or some of the things that are related to defense technology, I can appreciate that.

But on the other side of the argument, is that U.S. doesn't have monopoly over these things, that there's plenty of defense technology available in Europe or perhaps even Russia, so that the question is whether we can be successful in preventing the Chinese from getting some technology elsewhere that would be good for their defense? I don't know. So essentially I'm just giving you a few pointers. I haven't made up my mind.

HEARING COCHAIR WESSEL: Let me follow up on the first part of your question regarding profitability, and I had seen those figures regarding, if I remember, aggregate profits for U.S. foreign investment enterprise. I believe it was 4.4 billion.

China's entry into the WTO and the granting of PNTR by the U.S. was supposed to give us enormous new access to the Chinese market, 1.3 billion consumers. Tens of billions of dollars of investment has gone in, yet the return has been fairly limited. 55 or more percent of exports from China come from foreign invested enterprises.

These subsidies and the profitability issues seem to me to be directed at creating this export engine, to be able to create, as I think I believe it was discussed on the last panel, 100 million new workers will enter the Chinese workforce over the next decade. They have to employ them to be able to maintain control.

Have you been able to disaggregate the 4.4 billion? Is it serving the Chinese market? Is it those that are exporting back to the U.S.? And as we look at the larger question, since you turned to New York Times and other articles, Dr. Chow, in your own quotes, when you look at this from a U.S. congressional policy, and members of Congress, their job is to help build growth with equity here in the United States, these subsidies seem to be occurring at our own expense, that they are grabbing productive capabilities.

You talk about incomes and jobs being lost. How should we respond to that? Dr. Haley, the first question is whether you've been able to disaggregate, and then the larger question, Dr. Chow, if you could?

DR. HALEY: Those are very important questions. I've been talking about the murkiness of Chinese economics statistics, but foreign affiliates are also very secretive about their profits. A lot of the transfer pricing issues start coming in here. How much do you export and how do you evaluate productions?

Ball-park, I can say that the companies that export, as you pointed out, are mostly foreign companies. It reminds me of that old Pogo cartoon, "I have seen the enemy, and it is us."

Yes, it is us. However, the companies become exporters because they initially went there for the Chinese market and the Chinese market proved a mirage. It proved a mirage because the Chinese market has systematically been exaggerated. The automobile market in China is smaller than some of the smallest automobile markets in Europe, perhaps Spain.

The people are generally poor. You have very, very wealthy people. We met some when we were in China that would be onthe equivalent with the very, very wealthy here. The bulk of the people are not wealthy. The wealthy people can buy anywhere in the world. They don't have to buy in China.

So when you sell to that market, you have to make a great many modifications and you have to most importantly reduce price, and what does happen with the companies we looked at is when they introduce a product into the market, within about two or three years, there are rip-offs, and then within three or four years, they start competing on price alone, and the margins become razor thin, and they can no longer get any profits back.

Remember, these companies have invested a lot in brand name advertising, research and development; they have to get some returns on that. And very soon, they find the market has evaporated, and they're no longer making profits.

At this point, they have their facilities set up. They want to export. This is a vicious cycle because it has continued to contribute to a downward spiral in prices, and that is because the engines of production are there, and companies are there, and they've got everything set up. What do they do? They've got to shift their focus.

Philips is a company we studied that did this. They went there to sell television sets to a billion Chinese, and found that the market did not exist. However, the Chinese government started throwing subsidies, free land, free utilities, cheap labor, et cetera, and Phillips found out that it could manufacture and assemble cheaply. The Chinese are very good on the factory floor, and Phillips could export back to home markets.

So this is one of the things that is happening. There are ballpark estimates. I can't give you hard statistics, for various reasons, it’s not just the Chinese, but it's also our companies that are reticent.

HEARING COCHAIR WESSEL: Dr. Chow.

DR. CHOW: Yes. I'd like to make two brief comments. One is on the Chinese market related to this, and the second is the question you raised about the Chinese competition.

Now, about the Chinese market, let's get some facts straight. The automobile market in China definitely is bigger than the market in Spain, that China's annual sales of automobiles, passenger automobiles, it's six or seven million a year. I don't know the Spanish figure. I don't think it's that high.

The Chinese automobile market actually is pretty big. A lot of people have cars—not in terms of actual numbers—but the percentage is small. But China is a big country, and if you go to China, for example, I go to China two or three times a year, and I still have to catch up. For example, in Hangzhou, two or three years ago, there were very few cars. A year later, the streets were full of cars. You cannot imagine the rate of increase in the demand for cars. It's so rapid. So I'm telling you one thing about the automobile market.

The second is competition. It is hard to make money, but that's Econ 101, because you remember that for the U.S. automobile industry, in the teens, 1915 or so, or 1920, there were over 30 companies producing automobiles. Everybody started producing, and competition just forced a lot of them out, and by the time I came to the U.S. in 1948, there were four companies producing automobiles.

So the competitiveness of the Chinese market makes it very hard to make money. Econ 101 tells us that under perfect competition, the firms don't make money, and that is a sign of efficiency of that market. Now, as a producer, you won't be too happy because it's very competitive.

That's number one. The other point I think I was asked to comment on, what happened to the U.S. facing competition from China. I talked a little bit about U.S. workers losing jobs, that kind of issue. As far as the New York Times article made the point that the Chinese imports that come here, like textile products, are things that we don't produce so we're not losing anything. Imposing import restrictions only hurts the U.S. consumers that are benefiting from having these goods that we buy from Wal-Mart; right.

So they are not competing in the areas that we are producing, most of that. So that's one point. I am sort of a conservative economist. I got my Ph.D. from Chicago, so in general our view, economists differ on their viewpoint on globalization, I don't have to tell you about this. You know better than I do.

Some economists are more in favor of more letting more market forces work, and let competition be open, and some economists think that we should impose restrictions. So there are two schools of thought, there are pros and cons, and in such a short time I don't want to waste your time for me to discuss that long debate.

DR. HALEY: May I just add something to that?

HEARING COCHAIR WESSEL: Please, quickly, yes.

DR. HALEY: The boom in Chinese car sales was because of cheap consumer loans, and it has dropped. It has dropped like a brick.

HEARING COCHAIR WESSEL: I understand. We had testimony just about a year ago, if I remember, and we can have staff present some of the figures. The size of the Chinese auto market I believe was 3.5 million units of demand. They are now. within two years. going to have seven million units of supply, twice as much supply as demand. I think the figures are probably closer to that of Spain. I don't know what the size of their market is, but we'd be happy to share and have a dialogue on that.

Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you very much, both of you, for your testimony. I have a question for Dr. Haley. I look at China, in terms of the government trying to stay in power, a one-party country, the one-party system that doesn't have political legitimacy, and is playing with economic policies to stay in power.

So I look at your list of the 11th year program, the subsidies, and to me, you look at integrated circuits and new generation. What do you have? New generation networks and environmental and energy and resources and so on, and space and satellite. Most of these seem to be aimed at making the country a greater military and technological power.

DR. HALEY: Absolutely.

COMMISSIONER BLUMENTHAL: Versus the kinds of subsidies to deal with the types of social unrest that we've seen, the peasants and so on and so forth. I'm wondering, from a political economic perspective, do you see this as a greater priority than say the----there's been a lot of talk about how they're going to deal with the rural poor, but it seems like from your subsidies list, either there are certain groups that are more important to the maintenance of the government, or there are certain national priorities that are more important to the maintenance of the government?

DR. HALEY: Well, I think, Commissioner Blumenthal, you hit the nail on the head when you said this is an issue of control, and an issue of control for the central government, but there are also other issues--when it comes to subsidies, you're also talking about the local government' interests that come into play. So it becomes a little bit more less clear cut.

Let me talk about the central government. China is a military power. China is a world power. We just have to talk to its Southeast Asian neighbors to find out China is not saber-rattling, and they don't see it as doing such.

China also sees itself as a civilizational force. It sees itself as offering a counter-civilization to that of the United States. China has an enormously distinguished history of several thousand years, it sees what it can offer, and the priorities that it offers are different than those of the United States.

Individual freedoms are not part of the panoply of things that they're changing in China. I feel that Chinese government believes it can't be a force, a global force without having military ambitions. Most of these technologies that it desires are dual-purpose technologies.

COMMISSIONER BLUMENTHAL: How do they reconcile that priority with this enormous social unrest? Again, I tried to make this point beforehand, but we're not talking about pure economic maximizers who are in a free market trying to maximize GDP. We're talking about people trying to stay in power and have other priorities.

How do you reconcile the priority of that with the fact that they're having thousands and thousands of protests every year now?

DR. HALEY: And where do you read about them? You certainly don't read about them in the Chinese press. You can't even do a search of the Dalai Lama on China Google.

DR. CHOW: Oh, you do. The Chinese press has reports on protests.

DR. HALEY: I'm running a panel on Friday, and I would like to make a pitch for it; the panel includes several people who have actually testified before your commission on human rights in China, and several have been jailed in China.

DR. CHOW: That's a different point. We're talking about protests.

DR. HALEY: Jailed just for mild things, a few political slogans.

COMMISSIONER BLUMENTHAL: But the point on subsidies is that you see more of the state's funds going into national power than dealing with the rural unrest situation? More of the state's funds, more of the state's policies?

DR. HALEY: I can only offer guess work on this because the statistics are so murky. The Chinese government does not know what the true statistics are like, and I disagree with Professor Chow on this. I do not see the Chinese as being malevolent about this. I don't think they have the institutional structure to garner the kind of data that we in the United States rely on regularly and routinely.

Some of the information, of course, is disguised for several political reasons and to protect factions and other things. But the Chinese governments also have different priorities. Maximizing profits is not one of them. They actually don't care about maximizing profits or even making their subsidiaries--their SOEs the most efficient they can. They want them to be the largest they can so that they compete globally.

They want them to have, to get their foot in the door, just like our companies would. We advise our companies to get their foot in the door and have as many options as possible. They want their companies to do the same.

HEARING COCHAIR WESSEL: Commissioner Houston.

COMMISSIONER HOUSTON: My question is for both of you because I think there will be somewhat of a different answer, and it's very similar to what Commissioner Blumenthal was just asking as well.

This commission is not focused specifically on human rights, but certainly workforce issues enter into it, and as individual commissioners, we all have great concern for the Chinese people. We've mentioned before that part of the problem with the social unrest is you don't have economic growth accruing to the individual, it's accruing to the government blog or to the SOE or whatever. I'm struck by the notion that Chinese government policies seem to be reducing the ability of the Chinese consumer to buy what we've had manufactured in China.

We've had testimony before about the social unrest, people not receiving unemployment checks, or the Chinese version of social security. So the capital of the individual seems to be shrinking. You can't, to my way of thinking, separate the social unrest and the workforce issues.

So my question specifically is, as far as the budgeting at the governmental level, is it a global budget? Is there a mechanism established for balancing that money that is applied to subsidies for these companies versus that amount of money that's available for a social safety net for the Chinese people?

Second to that question is do you see a divergence of that or a convergence of that? I think that's the crux of my question. As the Chinese economy grows globally, do you see more or that subsidy being poured into the economic sector and pulled away from the personal sector, or, what is that dynamic?

So I guess the question is, are the Chinese people going to benefit more from this globalization and economic boom or are they going to benefit less if they are not the population directly involved in the manufacturing sector that's booming right at the moment?

DR. HALEY: Well you're talking about a quarter of the world's population, a billion people. There are no Chinese people. There are the Hans, the ethnic majority, then there are all kinds of different little groups, ethnic groups and others. It really would be the same thing as you would have here, who benefits? Everyone is not going to benefit equally.

China is routinely, along with other emerging markets, among the most corrupt in the world, so you have the problems of distribution of income, although there might be a rise in the income of the Chinese. I expect there will be a rising of income over time with China's joining the global community and the global economy, but who's going to benefit, and are these benefits going to be equally distributed are difficult questions to answer. For example, are the Tibetans going to be benefiting as much as the Eastern provinces--or are the western provinces, remote western provinces, going to be benefiting as much as the areas around Shanghai? I don't think so.

It's an educated guess. But I don't think so--

COMMISSIONER HOUSTON: Do you see, though, that money that's going into the subsidies growing and pulling away from the social safety nets in China, or do you think there is no real dynamic there?

DR. HALEY: Well, the Chinese government has to maintain its SOEs in order to maintain some degree of control over that society because, as you pointed out, the SOEs are their safety net, their social security mechanism.

However, they also have to restructure them in order to get these benefits--they've identified, I think about, 50 to 100 that they're going to be restructuring, to make them sufficiently competitive in order for them to grow large and compete worldwide. I think the rest will continue inefficiently.

DR. CHOW: Believe it or not, I happen to agree with everything Dr. Haley has said in the last two minutes. But I would like to supplement what she said to answer your question, Madam Commissioner.

First of all, about human rights in China. Although not your key question, I think that there is no question that by our standard, there are a lot of human rights issues. So, okay, we're not here to discuss that, it exists and you can raise that.

Now, whether China or the Chinese people have benefited globalization, like Dr. Haley, the answer is a definite yes. But some people have benefited more than others. Now, simply said, let me give you two statistics. If you look at income per capita of the urban population and the rural population, the urban people per capita growth is about 7-1/2 percent in the last 15 years. And the rural, it's 5-1/2 percent. So there's a big difference of two percentage points per year, but 5-1/2 is a very big percentage growth.

So the gap is getting bigger and bigger, but even the poor rural people are getting richer. They have been getting richer.

Now, if you look at the poorest of the poor, for example, if you look at the poorest province, which is Guizhou, their per capita consumption in the last 20 years has been growing at 3.5 percent per year.

Now, 3.5 percent per year is a pretty good figure, but compared to Shanghai, which is over ten, right, so these are the basic facts, that the poorest people are getting better off, but the gap between the rich and poor is getting larger.. That is a basic fact.

Now, you asked about how the government money is going to be used for subsidies or these other things versus social welfare. I think the government considers the problem associated with the poor rural population the three farm problem, meaning farming, farmers, and rural areas or, in Chinese, farm, farm, farm, right, to be the major issue of China's problem.

That includes injustice, like Dr. Haley was saying, that people who don’t get their paycheck. It was the farmers who go to work for government projects. When the central government sent the checks down to pay these people working in construction, and the local bureaucrats just took the checks and didn't pay the farmers. All this is true--there's a whole big story about it.

One aspect of that so-called three farm problem, for the farmers, for farming, and for the rural areas, is that the central government has considered it the major national problem included in the government’s “number one document” in the last three years. The central government sent something called the number one document, which means that this is the issue of most importance. That has been the most important issue. So Beijing realizes that. That doesn't mean that they can do something about it soon.

It's a very complicated problem related to corruption. It's very complicated, but the government has devoted and is devoting more and more resources for that problem, but money may not save the day.

DR. HALEY: Professor Chow raised a really important point. China currently has the largest gap between the rich and the poor in the world. That gap is the largest.

HEARING COCHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: They must need a good Communist revolution over there. I'm not an economist, but I want to thank you both very much for being here and for your very helpful testimony. Dr. Chow, I want to just ask you a few questions

You've mentioned there are two kinds of economists looking at globalization.

Are you a let-her-rip guy or are you a “slow-her-down” type guy, looking at globalization?

DR. CHOW: Oh, you mean people in favor of a slow globalization process?

COMMISSIONER MULLOY: Yes.

DR. CHOW: I think it depends on where. In China, in particular, I think that the Chinese government roughly did the right thing. The Chinese didn't open up their financial markets so easily. So in a way, China avoided the big impact of the Asian financial crisis of '97-'99. So if China had opened more, it would have had more trouble.

So that if you look back, the Chinese government roughly did the right thing. So I think that after the Asian financial crisis, some American economists--I don't need to name names--changed their minds. The people who were in favor of globalization at a fast speed, some of them say that, well, maybe we should be a little more careful. So my general answer is that for China, it may pay to proceed with moderate speed.

COMMISSIONER MULLOY: My understanding, and help me with this, is that the theory upon which this globalization is based is Ricardo's theory of comparative advantage.

DR. CHOW: Yes, partly. Actually, one of my favorite quotations is from a Chinese historian Sima Qian who wrote over 2,000 years ago. He was talking about free flow of resources, and essentially if the market allows free flow of resources so that resources, whether it's goods or capital or humans, would get the highest return. So that is the basic principle. Yes.

COMMISSIONER MULLOY: Now, my understanding is Ricardo's theory, which is always cited by as the basis for comparative advantage. In this country, economists always talk about it.

DR. CHOW: Correct.

COMMISSIONER MULLOY: To justify this.

DR. CHOW: Correct.

COMMISSIONER MULLOY: My understanding, and Dr. Panagariya confirmed this at a hearing we did in May up in New York. He said that theory is based on non-mobile capital and that Ricardo based his theory on non-mobile capital. Is that correct?

DR. CHOW: Well, yes, but then Samuelson.

COMMISSIONER MULLOY: I’ll stop there and go to the next question.

So if the theory is based on non-mobile capital, but you talk about in your testimony that the United States has an abundance of capital and that China has an abundance of labor, and as capital moves from the United States, it will lower the return to capital in China and lower the wage rate in the United States, but raise wages in China; right?

So capital is moving--

DR. CHOW: Correct.

COMMISSIONER MULLOY: --but that is not the theory of comparative advantage. This is some new theory. It must be.

DR. CHOW: Well, I wasn't quoting Ricardo when I said that. You see, Ricardo did something important, but I think we have advanced after that. I was talking about mobility of resources that would be beneficial.

COMMISSIONER MULLOY: Dr. Chow, you say in your testimony, in the long run, both countries, meaning China and the United States, will be better off as their national incomes will increase at a faster rate as a result of economic globalization.

I was reading a book by Dr. Baumol and Dr. Gomory--

DR. CHOW: Oh, yes, I know. Both are very good friends of mine.

COMMISSIONER MULLOY: Yes. They have a little different take. I think their book is called Global Economics and Conflicting National Interests. They say that this doesn't work out the same for both countries. That you can have some countries that are going to benefit very much from globalization and other countries that aren't going to benefit so much.

Do you agree with their theory on that?

DR. CHOW: Very good question. I'll try to put it in plain language. Much of the so-called neoclassical theory of international trade assumed the production function is smooth--such as the production function, output depends on capital and labor, say log output is a constant, plus A times log capital plus B times log labor. That kind of function is a smooth kind of a function, whereas Gomory's work on mathematical programming emphasized corner solutions, discrete corner solutions.

So that if you have corner solutions, that kind of thing can happen, so that whether I agree with Gomory-Baumol versus the neoclassical theory depends on which model has more relevance in the world, whether I think that the neoclassical type of production function is more relevant in the real world or the Gomory type production function with corners solution is a more relevant model of the real world. So that's very hard to argue.

COMMISSIONER MULLOY: Okay. Now, I want to be like Harry Truman. He said economists were two-handed economists, on one hand, on the other hand, and Harry Truman said he wanted a one-handed economist.

DR. CHOW: Okay. I can tell you one hand.

COMMISSIONER MULLOY: Where do you come down, the Gomory-Baumol or the neoclassical?

DR. CHOW: I come down with neoclassical because I know that Baumol and Gomory are logically correct, and they emphasize the cases which they consider very important. In my humble judgment I think that if I have to choose the two--I think their examples are more often the rule, but I have given you the more likely hand.

COMMISSIONER MULLOY: One last question. You don't discuss exchange rates very much in your testimony.

DR. CHOW: Right.

COMMISSIONER MULLOY: There will be a panel later that says that's an enormous factor here.

DR. CHOW: Right.

COMMISSIONER MULLOY: When a country was intervening in currency markets to keep an undervalued currency--

DR. CHOW: Right.

COMMISSIONER MULLOY: --that that has tremendous influence on where capital is going to flow, where manufacturing is going to flow, where technology is going to flow. So if you do that, you can gain a big advantage over your competitor who is not doing that.

DR. CHOW: I have a paper on that. But if you allow me whatever time you can give me, I will give you the summary of what I have to say about that issue. But you may pass it. But if you give me—a half a minute, one minute, two minute, I can give you--

[Note added after the hearing by Dr. Chow concerning his paper "Globalization and China's economic development" submitted for the record: This paper also discusses the possibility of one country gaining and another country losing out through trade and the mobility of resources and technology, as raised by Commissioner Mulloy quoting the Baumol-Gomory book, by using a 2004 paper of Paul Samuelson which also discusses the same possibility.]

HEARING COCHAIR WESSEL: Take 30 seconds.

DR. CHOW: 30 seconds, I think that it is to the advantage of China itself to revalue. You know why? Because the undervalued currency has created a lot of capital flows through trade, through investment, into China.

When foreign money goes to China, and people convert that money into Chinese money, that would create a rapid increase in money supply. That happened in '02 and '03. Now, Milton Friedman had this proposition, which actually I learned from Ben Bernanke, which says that when there is sort of outside increase in money supply, there are two impacts.

Output would increase within a few months, but the effect on output would die down. Second, prices would go up later, but more permanently. That's exactly what has been happening in China. In '02 and '03, China got an overheated economy, and output investment first increased, because the banks had too much money, and then prices went up later, and it's a Friedman proposition.

So they had trouble in controlling the overheated economy. So for the good of China, China should revalue its money, but my time is up.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR WESSEL: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you.

DR. HALEY: Most economists make ceteris paribus assumptions, that is all things being equal, but all things are not equal. So it really depends on the kinds of assumptions you relax and which ones you keep.

The models are extremely elegant, and they explain quite a bit; but the more data you put in, the more reality you put in, the more murky the models become, and —then the models don't explain much at all. So economists like keeping their models simple.

DR. CHOW: Before you say anything, you have to know something about the model.

DR. HALEY: Well, that's true. And which economist and which assumptions you are endorsing--I'm not an economist.

HEARING COCHAIR WESSEL: Commissioner D'Amato.

COMMISSIONER MULLOY: Thank you.

COMMISSIONER D'AMATO: Thank you. Thank you, Mr. Chairman. I want to pursue that line, this question of assumptions with Dr. Haley. This Commission was created to connect the question of long-term national security of the United States vis-à-vis China with the growth of economic flows that are continuing with China.

So what you say about government control is very important to us. My question to you is this. If government control is pervasive, if government control has become a crutch that stifles long-term innovation in China, and together with that, the introduction of the technology of Western multinationals that can be copied without Chinese developing innovative capacity, and you have a long-term incidence of massive corruption in the system as well--all these things we've had testimony on--at some point doesn't the system stall out?

Can you have your cake and eat it too? DR. CHOW: Yes.

COMMISSIONER D'AMATO: In the long run, doesn't this kill the goose that lays the golden egg in China because they cannot develop the kind of innovation to maintain the growth of superpower status vis-a-vis the United States, that they cannot develop the kind of innovative capacity that we have?

Now where do you see that?

DR. HALEY: I agree. The United States is number one, the most competitive country in the world. It becomes very difficult to move from number two to number one really. If you look at other competitive countries, and you look at for example Finland or Singapore, they're all very competitive because they all run very well. They have taken full advantage of their competitive and core competencies. But to really compete at that level, you have to make massive institutional changes.

COMMISSIONER D'AMATO: Yes, so to take it one step further, without serious political reform, this system in the long run doesn't work?

DR. HALEY: That's right.

COMMISSIONER D'AMATO: Is that what you think?

DR. HALEY: That's right.

DR. CHOW: Can I say something on this regard or not?

COMMISSIONER D'AMATO: Yes.

DR. CHOW: Well, definitely. Innovation-wise or technology-wise, China is far behind the U.S. Okay. We all understand that. Now, to say that the government is so bad as to stifle innovation in China in a way that China would never catch up with the U.S., I think that's wishful thinking.

That's wishful thinking. I don't have time to elaborate. In spite of the shortcomings of the government, there are a lot of innovations in China. China now is moving professors from Princeton to Beijing. Believe it or not, the top professors in some universities--not all of them--and it's phenomenal. The government actually in a way encouraged research in science and technology.

So the government is not that stupid. So don't underestimate.

DR. HALEY: China has 1.6 million engineers. The estimate is about 160,000 of them can really be used by multinational corporations. The numbers are not really good indicators of the quality. We've talked to so many business people. They say that the Chinese engineers are very good, for example, at mathematics. —However, when it comes to thinking outside the box, to confronting new problems, there they falter. Okay.

DR. CHOW: Correct.

DR. HALEY: The institutional structure hasn't permitted them to take risks, to suffer criticism openly. All of these things are important for innovation.

COMMISSIONER D'AMATO: So if you want to stifle China's long-term growth, we use our secret weapon: we export multinationals.

DR. HALEY: We also endanger ourselves by doing that just willy-nilly and without black-boxing in some way our core technologies because we have put a lot into them. And we cannot expose ourselves without risk--

COMMISSIONER MULLOY: Mr. Chairman, can I make one point on Commissioner D'Amat's question? I noteed this week an article from Business Week on the point. It says that Intel has just invested $1.3 billion in chip assembly testing and research and development in China. So obviously the companies think that they've got some talented people over there who can move up the technology chain pretty rapidly because they're putting a lot of R&D into China.

DR. HALEY: Well, to give you a counter-example, Microsoft engaged in what we call the most expensive kowtow in the world. They've put up research and development institutes that will help the Chinese to steal their technology in the future. Microsoft really thinks ahead. And they have never made a profit in China, never. They do not estimate making a profit in China for the next 20 years. But just because they're there doing these things doesn't mean that they anticipate making profits soon.

HEARING COCHAIR WESSEL: Commissioner Reinsch for a closing question.

COMMISSIONER REINSCH: I want to try again with Dr. Haley. I wanted to try to see if you can disaggregate the subsidies that you talked about a little bit.

It seems to me that some of them are for research, primarily research and development for forward-looking industries of the future, you might say.

I gather also though that a substantial number of them are essentially to keep afloat inefficient industries, SOEs, and they're essentially operating subsidies. Do you have any sense of how much is in one category and how much is in another?

DR. HALEY: No, I'm sorry, I don't.

COMMISSIONER REINSCH: Okay. Can you comment on, from the United States point of view, which ones are the most problematic for us?

DR. HALEY: Well, it really depends on whom you're asking, I would think--

COMMISSIONER REINSCH: I'm asking you.

DR. HALEY: Yes. Well, we don't really know. I guess the dual purpose technologies might be a real threat, and most of their technologies now, the ones that they're looking at are dual purpose. But things such as energy, investing in more energy efficient industries, getting renewable resources, those things could help us as well. It would reduce global warming, so I don't really think there's an easy answer to that.

COMMISSIONER REINSCH: Are the subsidies in that category, the dual use subsidy category, are the Chinese unique in employing that tool?

DR. HALEY: I think they've been fairly successful in it.

COMMISSIONER REINSCH: Yes, but are they the only ones?

DR. HALEY: No.

COMMISSIONER REINSCH: Ahh. Who else?

DR. HALEY: Israel maybe.

COMMISSIONER REINSCH: Not India?

DR. HALEY: India, yes.

COMMISSIONER REINSCH: How about the EU?

DR. HALEY: I’m not really familiar with instances there.

COMMISSIONER REINSCH: How about us?

DR. HALEY: Yes. As a matter of fact, we were the only country in the world to ever have stealing of technology as an official policy. This was around our independence--

COMMISSIONER REINSCH: Thank you.

HEARING COCHAIR WESSEL: Thank you to both the panelists. I hope you will be able to respond to some follow-up questions. Dr. Haley, for example, your testimony talked about the PLA still controlling 80 percent of the distribution of goods, and we've all been told that the PLA has been backing out of the commercial sector. So for both Dr. Chow and Dr. Haley, we may have some follow-ups, and thank you for being here.

We're going to take a five minute break before the next panel, and thank you.

DR. HALEY: Thank you for having us.

[Whereupon, a short break was taken.]

PANEL IV: CURRENCY MANIPULATIONS AS AN INDUSTRIAL SUBSIDY

HEARING COCHAIR WESSEL: On our second panel this afternoon we have with us a number of friends who have worked with us, appeared before this commission, and we're happy to have them back.

We have Fred Bergsten, Director of the Institute for International Economics. Dr. Bergsten was Assistant Secretary for International Affairs at Treasury Department from 1977 to 1981. He also served as Under Secretary for Monetary Affairs and represented the U.S. on the G-5 Deputies Group, and in preparing for the G-7 Summits.

Next, we have David Hartquist of the Collier Shannon law firm. Mr. Hartquist serves as chairman of the firm's International Trade and Customs Practice Group. Mr. Hartquist is also a member of the China Currency Coalition, which presented a 301 petition to the USTR against China's currency manipulation, and continues to advocate on this issue.

Finally, we joined today by Bob Baugh, Executive Director of the Industrial Union Council at the AFL-CIO. The AFL-CIO has cited the failure to brand China as a currency manipulator and has suggested imposing economic sanctions as a way to deal with America's trade deficit. The AFL-CIO has been a leader on the labor rights issue as well.

We will open up for seven to ten minutes of testimony from each of the panelists in the order in which I introduced them, and then we'll be recognizing our commissioners for five minutes each and hopefully we'll have enough time for two rounds of questions.

Dr. Bergsten.

STATEMENT OF DR. C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

DR. BERGSTEN: Thank you, Mr. Chairman. It's a pleasure to appear before the Commission again. I sent you for background a copy of a statement I gave last week to the Senate Finance Committee on

U.S.-China economic relations, which addressed the three main issues that you have raised for today's hearing.

So let me just summarize quickly on each of those topics. Your first question, how does China's undervalued currency impact the U.S. economy? China's undervalued currency in my view has a very large effect on our global current account deficit, which is hitting an annual rate of $900 billion in the fourth quarter of last year, and is predicted it will be headed toward a trillion dollar annual rate sometime soon.

Now having said that, one has to note that a current account deficit and an overvalued dollar, in our case, have dual effects on our economy. They have some favorable effects. They keep down the prices of imports. They therefore help hold down inflation. When other countries pile up reserves as a counterpart of their surpluses, they put the money in here, it holds down our interest rates. That can also help counter inflation and actually stimulate growth for a while.

The adverse effect, of course, is that the undervalued foreign currencies and corresponding overvalued dollar hurt our competitiveness in global markets, create a large and growing trade and current account deficit which is, in my view, clearly unsustainable for lots of reasons, and in the short run has an adverse effect on job creation and economic growth, particularly in the tradable goods sectors that are affected by the currency relationships.

In macro terms, there is a tradeoff. The favorable effects of lower inflation and lower interest rates do promote faster economic growth and higher output and actually job creation that has to be set against the negative effects that come through the direct loss of trade competitiveness through the currency misalignment.

Since I happen to think that these big imbalances are unsustainable over time, what we gain in the short run, we're likely to pay back in the longer run, but there is an argument that a lot of people make that it will be sustained longer than we think. It's already in fact, been sustained longer than I would have thought, and so one cannot dismiss the fact that there is a favorable side to the equation, though I would stress, I believe, it's unsustainable and you ought to take steps to head it off including in particular avoiding continued long, large currency misalignment.

Your second question, does China's undervalued currency constitute an export subsidy? Absolutely. It also constitutes an import barrier. It's not only an export subsidy. It's also an import barrier. By mispricing the tradeable goods flows, it has the same effect as would a tax subsidy or an import tariff or any other device which distorts the pricing of internationally traded goods.

Now, I hasten to say that's an economic argument. Whether it constitutes an export subsidy in legal terms, I will leave to other members of the panel. I'm happy to opine on that, but I don't claim that's my expertise. But I do want to stress, if you look at it from

China's standpoint, I put a line in my testimony of last week, that I passed to you.

I think China views its undervalued currency as an off-budget export subsidy which avoids, at least so far, any effective international response. In other words, if you're a developing country, trying to promote your economic expansion, and the creation of jobs, undervalued currency is a very attractive policy instrument because it's off budget, you don't have to account for it domestically, at least so far, and we talk about that.

It doesn't generate usually very effective international response. So you get away with it internationally. So it's a pretty effective policy tool. In fact, if you look at the history of the development of success stories in economic growth terms around the world, an undervalued currency is frequently a part of the package, and whether it's Japan, Korea, Taiwan, lots of other countries around the world, currency undervaluation has been an explicit element of a development strategy, and we're seeing that I think now in spades in the case of China.

Many of those countries have been small enough that it didn't make such a big effect internationally that they escaped attention. Not true for Japan. Increasingly not true for the Asian NICs in the late '80s and early '90s, certainly not true of China now.

The second part of your second question, if so, does this violate any of its international agreements, I would argue it does, and I'll leave the WTO arguments to Mr. Hartquist, but I think it violates their IMF commitments, because the IMF has very firm rules against, quote, "competitive undervaluation of currencies." And has very explicit rules against, quote, "large protracted one-way intervention in currency markets" to maintain currency undervaluation.

So I believe China is violating its IMF obligations. Unfortunately, the IMF has not sought to enforce its obligations, and therein lies much of the problem.

But in my view, in my reading, and many things I've published, my colleagues at our Institute for International Economics have published, seems to us very clear that China is violating those commitments that it undertakes as a member of the IMF, and the problem lies with the IMF and its main members, starting with the United States, the biggest shareholder, for not insisting on enforcement of those rules. So those are my answers to your second question.

Third, what remedies exist to amend an undervalued currency? That of course is the tough question. Now frequently, there are domestic costs to maintaining an undervalued currency that induce a country to cease and desist, primarily inflation.

If you maintain an undervalued currency, that means imports are higher priced than they should be and that adds to inflation. You've got demand for your exports in excess of what normally would be the case, puts pressure on resources, and adds to inflation.

So frequently, in historical terms, when countries, particularly large industrial countries have had prolonged undervaluation of currencies, domestic adverse effects have come into play, and have prompted them to change the situation and revalue.

It looked like that was beginning to happen in China a couple of years ago in 2002-2004, when China began to experience substantial overheating, inflation picked up, on some measures close to double digits.

It looked like the Chinese were beginning to see the case, and some Chinese unequivocally did see the case, for revaluation to help fight domestic economic risks to their expansion, to their recovery.

Unfortunately, what they did instead was revert to a lot of their traditional command and control devices, told the banks to stop lending to sectors A through J. That cooled the overheating, at least for a time, and took the inflation pressure off the currency issue.

I suspect you were speaking particularly of international remedies to amend an undervalued currency. It may amuse you historically to recall, if you didn't know that already, that the original IMF Articles of Agreement, as crafted by Keynes and company in the end of the war period, actually had a very tough remedy against currency undervaluation and excessive trade surpluses, and that was called the scarce currency clause.

It empowered the IMF to declare a currency scarce and to permit other countries to discriminate against that country if it was recalcitrant in permitting its currency to go up in value and to run down its surpluses.

Now, needless to say that clause was aimed at the United States, because in the early post-war period, the fear was dollar shortage. The U.S. was going to make everything, pile up all the reserves. Indeed at the end of the Second World War, the U.S. owned 60 percent of world gold reserves, so everybody feared the U.S. was going to dominate the world and put in this clause to stop it.

Well, the clause didn't stop the U.S. The problem became a non-problem, but that clause just turned out to be non-functional, never worked and was abolished. At the moment, therefore, the IMF really has no effective tools to implement its own rules, as I described before. The best it can do is name and shame.

There are remedies which the IMF has not applied to undertake special consultations with a country whose currency is declared to be violating the rules that I mentioned before. The IMF in my view should have done that long since, and certainly should do it now. At a minimum, that would name and shame, bring pressure to bear.

Now, again, with most currencies, a name and shame campaign of that type would be quite effective because it would trigger market pressures on the currency. If the IMF goes explicitly after a country for maintaining undervalued currency, and publicly and globally indicates as such, money will pile into that currency, speculating that it will eventually revalue and create a self-fulfilling prophecy and the exchange rate will be driven up.

Again, unfortunately, in the Chinese case, there are extensive exchange controls that limit, don't eliminate, but limit the impact of that kind of pressure. The Chinese are experiencing and continue to experience substantial capital inflows speculating on currency revaluation as well as because of their big trade surplus and direct investment inflows.

The Chinese, and that's the nub of the problem, continue to intervene to the tune of 15 to $20 billion per month buying dollars to keep their own currency from rising in value, and that's how they manipulate and maintain the undervalued currency.

Indeed, I don't know if you've caught up with that, anybody has mentioned it to you, one of the leaders of the Chinese, the National People's Congress, was widely quoted by the media today as having said China may stop buying foreign currency and stop putting money into U.S. Treasuries and all that, with the implication that would be terrible.

Well, in my view, that's just what we want. I just did a couple TV interviews saying that. That's what we want. If they would do it, that would be a great thing. It would make Hu Jintao's visit a success. Otherwise, things may not go down so well.

But the problem is there's not such a good menu of remedies available right now, unless, unless--and I'll defer on that--one could implement the IMF rules to declare a currency as undervalued, in violation of the IMF rules, and then on the basis thereof, which is the argument to my left, get a WTO finding that such currency undervaluation in term represented an export subsidy.

Final point. In practice, there have been international sanctions in the past against undervalued currencies. They were carried out by the U.S. government on a bilateral basis and driven almost wholly by congressional pressure. There have been two instances of that. The first was 1971 when the Nixon administration determined that to head off the first spate of post-war pressure for protectionism in the Congress, it had to get a dollar devaluation, but couldn't do it under the fixed exchange rate system of the day without a negotiation.

So to prompt that negotiation, the Nixon administration applied an across-the-board 15 percent import surcharge and took the dollar off gold, thereby ending the fixed exchange rate for the dollar. There was much messiness over the next few months. Over the next two years, the result was about a 20 percent pair of devaluation of the dollar, cumulative effect 20 percent, but it was determined by the U.S. government, the administration, in response to congressional pressure, deciding that it, the U.S., needed a devaluation of the dollar.

The second case was the mid-1980s when Secretary of the Treasury Baker initiated the Plaza Agreement, not in response--again, not in response to fear that foreign investment in the dollar was going to dry up, but because Congress, as Bill Frenzel said at the time, was ready to adopt the Smoot-Hawley tariff itself if it came to the floor.

Therefore, the Reagan administration, like the Nixon administration, having lost control of the issue to the Congress, decided it wanted to seize it back and did so in their case through the Plaza Agreement, which was much more amicable than 1971. It was basically agreed with the rest of the G-5 to drive the dollar down, as it turned out, by 50 percent over a three-year period.

And that did indeed lead the U.S. current account deficit to almost disappear by 1990-91. It worked just like a textbook would suggest. But the point was that to get the undervalued currencies, at that time the yen and the European currencies, to revalue, the U.S. administration had to launch a major initiative. It did it in 1971. It did it in 1985. My sense is it's going to have to do it now or else it too will lose control of the issue to Congress, and the global trading system may be at risk because of this big monetary misalignment.

HEARING COCHAIR WESSEL: Thank you. Mr. Hartquist.

STATEMENT OF DAVID A. HARTQUIST, COLLIER SHANNON SCOTT PLLC, ON BEHALF OF THE CHINA CURRENCY COALITION

MR. HARTQUIST: Thank you, Mr. Chairman. I'm David A. Hartquist of the law firm of Collier Shannon and Scott, and counsel to the China Currency Coalition.

It's a pleasure to be on this panel today appearing again with Dr. Bergsten, and I would like to suggest that if the President is looking for a new Secretary of the Treasury in the next few months, Dr. Bergsten would be a great choice.

You have my full endorsement for what it's worth.

CHAIRMAN WORTZEL: Does your law firm need more employment?

MR. HARTQUIST: I'm also pleased to be here with Bob Baugh. unions that he represents in the AFL-CIO are part of the China Currency Coalition and very active in our work.

First of all, to Fred's comments, it really is an ironic situation that the IMF does not have enforcement authority, the WTO we think does have enforcement authority, but Pascal Lamy says we ain't getting into this, and the U.S. government we think clearly has options that it can pursue, but simply has been unwilling to do so thus far.

With respect to the Commission's questions, first, it's very evident to us that China's undervaluation of its currency is playing a very significant role in a series of worrisome developments for the United States. Shutting down companies and letting go workers in critical industries, selling assets, relocating to China, investing in China rather than in the United States, while borrowing excessively to consume low-priced dollar-denominated imports from China, are not sustainable or desirable actions.

This shortsightedness already has been very costly, and if allowed to continue, almost certainly will exact a greater and greater toll on the economy and security of the United States.

The yuan's undervaluation has been a driving factor underlying these dangerous trends. Commercially realistic reevaluation however accomplished would encourage a healthier engagement by China with the United States for everyone's sake.

China, we continually point out, continues to hide the ball in issuing false government statistics. The trade data is simply incorrect and we've shown many times in the releases and the analyses that we've done why that's the case. Just look at the partner trade data and you'll see what the real numbers look like.

But U.S. and IMF officials appear to continue using this phony data without challenging it.

Second, very little progress has been made on the issue over the past year. The revaluation last July is no substitute for the 40 percent revaluation that we believe is needed. If China's system were truly market driven, the daily trading band of plus or minus .3 percent could already have resulted in a 40 percent reevaluation of the yuan as of late March.

In other words, if they hadn't continued to control their currency following last July's announcement, we believe the 40 percent revaluation would have occurred based upon market forces as of the end of last month.

The problem is that China's leadership evidently remains convinced that the policy of enforced undervaluation is advantageous for China’s export-led growth.

China has been very clear with the IMF and the WTO that the Chinese government places tremendous importance on its exchange rate regime, as a means to foster economic growth and employment through exports and to encourage macroeconomic social and financial stability in China.

Third, China's undervaluation runs counter to its obligations in the IMF and the WTO. Most notably, the undervaluation should be considered and treated as a prohibited export subsidy within the meaning of Articles 1, 2 and 3 of the WTO Agreement on Subsidies and Countervailing Measures, and Articles 3, 9 and 10 of the WTO Agriculture Agreement.

All the earmarks of such a subsidy are present, and I deal with this more explicitly in my written statement. Thus, in a typical export transaction, having paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate, in effect. In this sequence of events, the criteria to establish a prohibited export subsidy are satisfied.

(a) The Chinese government provides a financial contribution of funds and services to the exporter by converting U.S. dollars into yuan and, if you will, sterilizing the yuan to control inflation in China.

(b) Due to the Chinese government's controls and measures, a benefit is conferred to the extent that the exporter in China is better off as a result of being given more yuan than if there were no undervaluation.

And (c) the subsidy is contingent upon export performance. All the elements are there.

What recourse does the United States have to address the issue? Unfortunately, there is no way to compel China to revalue. And the IMF, as I noted, has no dispute settlement mechanism or effective means at its disposal to sanction China. And while the WTO has a dispute settlement mechanism, earlier this year, as I also noted, the Director General Pascal Lamy was quoted as saying that to his knowledge, currency manipulation does not belong in the WTO's legal order.

So what is the United States to do? The issue of exchange rate manipulation is hybrid in nature, a monetary policy that has far-reaching effects on trade.

Consequently, even as the IMF Articles of Agreement obligate China not to manipulate exchange rates, there is a strong case that the yuan's undervaluation is a prohibited export subsidy under the WTO's provisions. Such as subsidy is countervailable if the subsidized imports injure or threaten to injure a U.S. domestic industry.

This legal theory is incorporated in and is the centerpiece of legislation that you're familiar with, the so-called Ryan-Hunter bill, H.R. 1498, which now has 158 co-sponsors and extensive bipartisan support.

The imposition of countervailing duties to offset injury caused by imports subsidized by undervaluation would be unprecedented, but at the same time, this approach can appropriately be and forcibly be defended as WTO consistent despite Mr. Lamy's general remark.

Most practically, that legislation would enable U.S. industries and workers to take corrective action against injurious subsidized imports and hopefully would give China and other countries engaged in currency manipulation pause to reconsider the value and the wisdom of such schemes.

Thank you.

[The statement follows:]

Prepared statement of David A. Hartquist, Collier Shannon Scott PLLC, on behalf of the China Currency Coalition

Good afternoon. Thank you for inviting me to participate in this hearing on behalf of the China Currency Coalition ("CCC"). The CCC consists of U.S. industry, agriculture, and labor organizations, and its purpose is to support the economy and security of the United States by working toward and achieving as promptly as possible commercially realistic appreciation of China's undervalued yuan.

Since I last appeared before the Commission on February 3, 2005, I think it is fair to say that there has been no significant shift in the Chinese leadership's basic position on the yuan. There certainly has been some activity by China, notably the changes that were announced on July 21, 2005: the yuan's one-time revaluation of just over two percent; the replacement of the yuan's peg to the dollar with reliance upon a basket of currencies; and the institution of a daily trading band of +/- 0.3 percent. But these modifications in practice have meant only a slight appreciation of the yuan against the dollar – from 8.28 yuan prior to July 21st to 8.01 yuan per dollar as of the end of last week, or approximately 3 percent. Exactly how modest this movement over the last eight and one-half months has been can be seen when it is recognized that a truly market-driven system – even with the narrow, daily trading band – could already have resulted in a forty-percent revaluation of the yuan as of late March. The CCC continues to believe that an appreciation in the range of forty percent is desperately needed.

As far as the United States is concerned, the ineffectiveness of China's revised system should come as no surprise. China has been very clear, for example, both with the International Monetary Fund ("IMF") and with the World Trade Organization ("WTO"): China's currency policy is meant foremost to achieve for China economic growth, employment, and macroeconomic, social, and financial-sector stability. China's decision has been to permit only very slight change in the yuan/dollar exchange rate as the best way of accomplishing these goals while avoiding as much as possible depreciation of China's substantial investment in dollar-denominated debt. It is reasonable to surmise that, from China's vantage, there seems to be no reason to alter this approach in the time ahead. The desired growth is being accomplished with the assistance of the undervalued yuan, and the yuan's incremental appreciation thus far has worked to prevent excessive losses for China's holdings in U.S. bonds. In the judgment of the CCC, however, the yuan's undervaluation is generating dangerous and increasingly damaging economic imbalances for the United States, for the global community, and for China itself.

The Undervalued Yuan's Impact on the U.S. Economy

China's direct intervention in currency exchange as well as controls over capital movements along with rigidities in the banking and financial sector prevent market forces of supply and demand from determining an equilibrium exchange rate for the yuan. As a result, the dollar's value remains artificially high and the yuan's value artificially low. Thus, the United States is losing capital investment and manufacturing capability in a variety of important industries and is seeing skilled and unskilled jobs migrate to China at an unprecedented rate. Further, as of the end of February, the China Business News reported last week, China has now overtaken Japan to become the country with the largest accumulation of foreign reserves at $853.7 billion, up from $818.9 billion as of the end of 2005.

Those U.S. companies that have not already gone out of business or relocated to China are able to export relatively little to China in the way of manufactured items. The U.S. bilateral trade deficit with China in 2005 hit a historic high of $203.8 billion. U.S. exports to third countries also are diminished by the yuan's undervaluation. To a significant degree, the loss of U.S. sales to third countries can be attributed to underselling by imports into those countries from China.

The effect on the U.S. manufacturing sector has been most severe in employment. Manufacturing employment has declined over the last five years. In February 2006, manufacturing employment was 3 million lower than in February 2001. But manufacturing in many sectors has not recovered from the recession at the turn of the century. Industrial machinery, electronic products including computers, communications equipment, electrical equipment, electric lighting, batteries, and motor vehicles and parts are some of the sectors that have not fully recovered from the recession.

Significant quantities of needed raw materials are being purchased in the United States and elsewhere, sent to China, and then made by companies in China into value-added, downstream products for export by China to the United States and elsewhere. In prior decades, these raw materials were fabricated into finished and semi-finished products in the United States.

Reduced income and revenues for U.S. workers and companies mean erosion of the U.S. tax base and greater difficulty for state and local governments particularly to fund basic, much-needed infrastructural projects.

With its ever-rising foreign reserves noted above, thanks to the undervalued yuan, the Chinese government is using foreign exchange to purchase U.S. government and quasi-government debt and is increasing the money supply in China's banking system, which in turn lends funds to Chinese businesses that are creating further excess capacity. Much of these bank loans are applied to underwrite debt or otherwise subsidize China's state-owned banks and other favored industries in China to the detriment of U.S. firms.

The situation is made worse because other Asian countries, particularly Japan, Taiwan, and Malaysia, also maintain undervalued currencies in order to compete with Chinese companies in China and global markets.

In summary, China's undervalued currency is creating current account imbalances that threaten the global financial system.

The Yuan's Undervaluation Is A Prohibited Export Subsidy That Should Be Countervailed If China Insists on Continuing to Undervalue the Yuan

In its Accession Agreement with the World Trade Organization, China unqualifiedly committed to cease all export subsidies by all levels of government by the time of accession, December 11, 2001. Despite this pledge, China has persisted in its undervaluation of the yuan. Although the precise issue has never previously arisen in dispute settlement or apparently otherwise, the China Currency Coalition submits that the yuan's undervaluation is a prohibited export subsidy in violation of Articles 1, 2, and 3 of the WTO's Agreement on Subsidies and Countervailing Measures ("the SCM Agreement") and the parallel Articles 3, 9, and 10 of the WTO's Agreement on Agriculture that build on the SCM Agreement's provisions.

Under Articles 1, 2, and 3 of the SCM Agreement, a measure must satisfy three criteria in order to be considered a prohibited export subsidy. In essence, there must be a governmental financial contribution (Article 1.1(a)(1)), a benefit must thereby be conferred (Article 1.1(b)), and such a subsidy must be specific by virtue of being contingent in law or in fact upon export performance (Articles 1.2, 2.3, and 3.1(a)). The yuan's enforced undervaluation by the Chinese government meets each of these criteria.

In a typical export transaction, having been paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate in effect.

In this sequence of events, the Chinese government first provides a financial contribution of funds to the exporter by means of the service of converting U.S. dollars into yuan.

Second, a benefit is conferred by this governmental financial contribution that is equal to the difference between what the yuan would be worth if its value were set by the market and its artificially low value as the result of China's undervaluation of the yuan. With the yuan undervalued by approximately forty percent, therefore, for each U.S. dollar earned by sale of goods to the United States the Chinese exporter will receive eight yuan rather than five yuan. As this illustration demonstrates, the exporter in China is "better off" as the result of being given more yuan than if there were no undervaluation.

Third, and lastly, this subsidy is contingent upon export performance. Only after the exporter has been paid in U.S. dollars for the goods that have been exported to the United States is the exporter required to convert those proceeds into yuan.

The setting forth in these straightforward terms of why the yuan's undervaluation should be seen as a prohibited export subsidy is not intended to overlook various underlying and, in some instances, arguably contrary points that add complexity to the analysis. At least a few should be mentioned at this juncture, therefore, and there are likely others that might be advanced. Also importantly, due to incomplete transparency by China, not all facts and details are known about exactly how China's system functions. At the same time, however, in the China Currency Coalition's opinion the evidence that is available is more than adequate to support the conclusion that the yuan's enforced undervaluation is a prohibited export subsidy.

For instance, with respect to the criterion that there be a governmental financial contribution under Article 1.1(a)(1) of the SCM Agreement, such a finding can rest on one or more of several grounds. As suggested above, the Chinese government's exchange of yuan in return for U.S. dollars can properly be viewed as "a government practice {that} involves a direct transfer of funds," in line with Article 1.1(a)(1)(i). The yuan's undervaluation might also be considered a governmental provision of services under Article 1.1(a)(1)(iii), inasmuch as the Chinese government both exchanges the yuan for U.S. dollars and then "sterilizes" the issued yuan in order to avoid inflation and loss of value by the yuan within China. These services by China are financial contributions integral to the yuan's undervaluation. Further, to the extent that the Chinese government entrusts or directs private bodies to conduct the exchanges and "sterilizations" of yuan, that activity likewise can reasonably be seen as a governmental financial contribution under Article 1.1(a)(1)(iv).

With respect to whether the subsidy due to the yuan's undervaluation is contingent, in law or in fact, upon export performance, and so is "specific" under Articles 1.2, 2.3, and 3.1(a) of the SCM Agreement, it is evident that this subsidy in fact is tied to actual or anticipated exportation or export earnings within the meaning of the SCM Agreement's Article 3.1(a) n.4. It is also possible that Chinese law and regulations might expressly provide that this subsidy is contingent upon exportation, but China's failure to date to report its subsidies to the WTO and lack of transparency are impediments to ascertaining the actual circumstances in this regard. Another aspect as to whether this subsidy is specific concerns its availability also to those persons and entities in China that have obtained U.S. dollars by means other than through the export of goods or services to the United States. A similar argument was made by the United States unsuccessfully in dispute settlements involving U.S. cotton subsidies and tax treatment for foreign sales corporations, but successfully by Canada in a dispute settlement pertaining to dairy products. As long as it can be established that there is a clear distinction between the eligible domestic recipients and the eligible exporters and different conditions for each group to receive the subsidy, the prerequisite of specificity for a prohibited export subsidy should be met.

From a broader standpoint, there is the question of whether responsibility and authority over exchange-rate problems lies with the IMF or the WTO or is shared by these two international organizations. Opinions vary. Earlier this year, the WTO's Director-General was quoted as saying that to his knowledge currency manipulation does not belong to the WTO's legal order. This remark, however, does not seem to consider that prohibited export subsidies fall within the bailiwick of the WTO and that undervaluation of a currency like the yuan can be a prohibited export subsidy under the WTO's provisions without necessarily comprising "currency manipulation" within the IMF's definition of that term.

The Director-General's comment additionally appears not to take into account relevant portions of Article XV, notably Article XV:4, of the General Agreement on Tariffs and Trade ("GATT"), the gist of which is that member states shall not, by exchange action, "frustrate" the intent of the GATT and shall not, by trade action, "frustrate" the intent of the IMF's Articles of Agreement. An addendum to Article XV:4 elaborates on and gives a couple of examples of what is intended by use of the word, "frustrate." More exactly, this addendum notes that infringements of the letter of any of the GATT's Articles by exchange action shall not be viewed as a violation of the GATT if, in practice, there is "no appreciable departure from the intent of the Article." Also pertinent, Article XV:9(a) of the GATT holds that nothing in the GATT shall preclude a member state's use of exchange controls or exchange restrictions in accordance with the IMF's Articles of Agreement.

The purpose of Article XV generally may be said to be the harmonious working in tandem of the IMF's Articles of Agreement with the GATT and the WTO's other agreements. What is deemed by one organization as consistent with its charter should not be found violative of the other organization's charter if at all possible and *vice versa*. Toward this end, Article XV:2 of the GATT stipulates in pertinent part that in all cases in which the WTO is called upon to consider problems concerning monetary reserves, balances of payments or foreign exchange arrangements, the WTO's Member States shall consult fully with the IMF and shall accept the IMF's determination of whether action by a member state in exchange matters is in accordance with the IMF's Articles of Agreement.

It is apparent that the drafters of the GATT and the IMF's Articles of Agreement recognized that trade action and exchange action can overlap and that coordination on such occasions is desirable. As Professor Lowenfeld observes at page 501 n.5 of his book, "International Economic Law," there was an acute awareness on the part of the United States and other countries after World War II that the 1930s had seen frequent resort to many monetary devices, including use of exchange controls and competitive currency depreciation, that had undercut recovery in international trade.

Over the years, there has indeed been a need for international monetary-trade coordination, for example, with issues concerning restrictions on imports due to problems with balance of payments. On the other hand, there has been little or no discussion or occasion of relevance calling for coordination on issues of currency manipulation or undervaluation.

In November 1996, consistent with this historical background, the IMF and the WTO entered into an agreement (the Fund-WTO Cooperation Agreement, dated November 25, 1996) acknowledging the increasing linkages between the various aspects of economic policymaking and designed to facilitate linkages between the IMF and WTO. More precisely, paragraph 8 of this agreement provides that the IMF shall inform in writing the relevant WTO body (including dispute settlement panels) that is considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the IMF's Articles of Agreement. Paragraph 9 of this agreement also directs that the WTO's Director-General and the IMF's Managing Director shall ensure cooperation between the staffs of their two institutions and shall agree on appropriate procedures toward that end, including access to databases and exchanges of views on jurisdictional and policy issues. Article 10 of the Agreement obligates the staffs of the WTO and the IMF to consult with each other on issues of possible inconsistency between measures under discussion with a common member under the WTO's and IMF's agreements.

What might all of these provisions mean for the yuan's enforced undervaluation? The answer to this question depends in good part on whether this situation is viewed purely as a trade matter or purely as a monetary matter or as a hybrid of the two. If, as the China Currency Coalition believes should be the case, the yuan's undervaluation is considered to be a hybrid by virtue of being a measure that is both financial and trade in nature with serious effects on international trade, it remains to be seen if and how effectively the WTO and the IMF might collaborate with each other under the terms of their 1996 agreement to cooperate.

In sorting through this situation, it will perhaps also be helpful to keep in mind the earlier comment that currency undervaluation that is a prohibited export subsidy in the WTO's eyes is not necessarily currency manipulation as well under the IMF's guidelines in Article IV(1)(iii) of its Articles of Agreement and its 1977 Surveillance Decision. For instance, currency manipulation as defined by the IMF entails manipulation of exchange rates or the international monetary system "in order to" prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. The IMF's element of intent for currency manipulation is not present in the WTO's agreements on prohibited export subsidies. As discussed earlier, a prohibited export subsidy under Articles 1, 2, and 3 of the SCM Agreement exists if there is a governmental financial contribution, a benefit results, and the subsidy is contingent upon export performance.

Seen from this vantage, especially given that the IMF has no dispute settlement mechanism and, as a practical matter, no other effective means at its disposal to sanction China, even if the IMF were to continue to be reluctant to find currency manipulation by China recognition of the yuan's undervaluation as a prohibited export subsidy would – in a hopefully significant way – assist U.S. companies and workers in a WTO–consistent manner to weather the storm, hold China accountable for its unwillingness to let the yuan appreciate expeditiously, and possibly impress upon China that there are rules of law to be honored and logical costs and consequences to be borne if those rules are wrongly disregarded.

Under this approach, any dispute settlement that went forward at the WTO could involve consultation with the IMF on the question of measuring the amount of the yuan's undervaluation or, expressed within the framework of Article 1.1(b) of the SCM Agreement, the amount of the benefit of the prohibited export subsidy. As the IMF's 2005 Article IV Consultation – Staff Report commented at page 14, "Although it is difficult to reach firm conclusions about its extent, the continued strengthening of the external balance points to increased undervaluation of the renminbi, adding to the urgency of making a move." Although these words were written on July 8, 2005, before China's July 21st revaluation of 2.1 percent, their sentiment is even more valid today given China's substantially greater amassment of foreign reserves now than as of last July.

Finally, the China Currency Coalition submits that the best remedy to address the yuan's undervaluation is to amend the U.S. countervailing duty law so as to implement the SCM Agreement's provisions in a WTO-consistent manner and treat undervaluation of the yuan or any other currency as a prohibited export subsidy. H.R. 1498, the Ryan-Hunter bill, with 158 co-sponsors and bipartisan support, adopts this strategy. If a U.S. domestic industry were found to be materially injured or threatened with material injury by reason of imports so subsidized, countervailing duties would be imposed to offset that injury. If China chose to take the United States to dispute settlement at the WTO, it could do so. On the other hand, if China decided to react by allowing the yuan promptly to appreciate in accordance with market forces, so much the better. If other countries like Japan, Taiwan, and Malaysia followed suit, better still.

Thank you for inviting me to appear before you today.

HEARING COCHAIR WESSEL: Mr. Baugh.

STATEMENT OF ROBERT BAUGH
EXECUTIVE DIRECTOR, INDUSTRIAL UNION COUNCIL
AFL-CIO

MR. BAUGH: Thank you, Mr. Chairman, members of the Commission. I'm glad to be here today to be able to speak with you and to join this panel of my colleagues. I will not repeat currency manipulation comments that Skip has done so well. We've spent the last two-and-a-half years working together on this issue.

What I would like to do is draw some attention to a couple of the other illegal subsidies that are there that have just as much of a damaging effect as the currency. We've often said the issues with China are not a silver bullet solution, but, in fact, they're multiple and they're complicated.

We agree that our country is on a very dangerous path and that it is unsustainable. You all know the deficit with China had $201 billion last year. The Economic Policy Institute estimates we lost 410,000 jobs and job opportunities to China alone over the last two years.

It's a sad but true fact that our largest export to China is empty cargo containers. I like to draw a visual picture of what is happening in our economy with our jobs and our country. Our imports from China outstrip our exports by more than five to one. It's the most imbalanced trading relationship in the world, and we've lost over three million manufacturing jobs in the last five years, and there is a relationship with China in the midst of all this.

Skip made a comment earlier on currency. I think it's important. It was about the trade figures that are used and that our own government uses that the Chinese produced that are wrong, and this gets to the issue of transparency and understanding subsidies and how this works and how dangerous and how difficult it is to obtain accurate information.

I heard that from the previous panel up here talking about the very same issue. We continue, as a government, to go after looking through the transitional review mechanism for the WTO to try and demand and understand the regime of subsidies that are out there.

Currency manipulation we've already talked about, but let's talk about other free money, as I call it, the nonperforming loan practice. The deliberate extensions of billions of dollars of nonperforming loans by China's central banks are giving another unfair advantage. The lack of transparency again makes it very difficult to understand how large it is. The estimates range from $400 to $650 billion.

The IMF economist estimate that it may have amounted to as much as 30 percent of China's GDP in 2003. It is significant. It is extensive, and for the fact that businesses can stay in business and don't pay their bills, again, creates a competitive disadvantage.

There are other forms of direct and indirect subsidies. Senator Lieberman did a very interesting piece that I thought captured what is happening in just one simple sector of the manufacturing economy. He wrote a piece on the semiconductor industry. And this is where, this is the nexus of industrial policy and illegal subsidies of where they come together. He looked at what this Chinese decision, strategic decision, was to capture this industry and control it and be able to capture monopoly power around it.

He looked at the subsidies and what do we find? Substantial rebates on the value added tax charged on Chinese-made chips, the development of special government-funded industrial parks, land, buildings and infrastructure for those parks, a very low cost of construction, and frankly a disinterest in the expensive pollution controls required of fabrication facilities in the United States.

There's a study that just came out recently that I refer to in my testimony that looked at the Pearl River data, and they just concluded that exported goods from China are cheaper to produce due to low or nonexistent emission controls.

But I think the other point I just made about cheap construction, there's a study that came out today, and I'll make it available to the committee. It was just filed with the WTO from the International Confederation of Trade Unions that looked at China's obligations under labor rights under this, and they discovered and even the Chinese themselves report that there's over $100 billion in unpaid wages to migrant laborers in China. 70 percent of it is in the construction industry.

People build things and they're not even paid for building them. That brings me to our point on the violation of workers and human rights. There is a systematic repression of these rights in China, affecting over 100 million manufacturing workers.

China's exports enjoy access to this U.S. market, but, in fact, they do not enforce wages, hours and health and safety rules. It is either lax or nonexistent. Workers do not have the right to freely form unions and bargain collectively.

It creates an environment where you can pay illegally low wages and thus profit from the widespread violation of these rights. In addition, there are an estimated 20 million child workers in China. From one-eighth to one-quarter of the number of factory workers that are there. And the problem with child labor has increased in recent years, as documented by various international groups and our studies from our State Department and others.

China also oversees a system of forced labor. It's estimated to be from 1.75 million workers to six million workers and higher. The House of Representatives would confirm that goods produced in China by forced labor continued to be exported into the United States in 2005.

This report itself I think cites the crux of the issue. And it says that the People's Republic of China have WTO obligations to pass the core International Labor Organization conventions around workers rights. China has passed four of them, and the review of these, they still continue to restrict trade union rights of workers.

There are problems of discrimination with child labor, with forced labor and a refusal to comply with these commitments. All of these lead to unfair advantages, certainly as you produce products.

They have not ratified the core conventions on the right to organize and collective bargaining, nor on the freedom of association and protections of the right to organize. They have ratified the convention on the worst forms of child labor, but in fact, it has admitted that it's not enforced and is a widespread problem.

They have not ratified the convention on the abolition of forced labor or the convention of forced labor.

These policies amount to what is a deliberate and artificial suppression of wages below what a really bargained labor market and situation would be. We believe these pointed out are in direct violation of the WTO and has been submitted in this recent report.

We took action on these, similar to what we did with the China Currency Coalition, to use our own laws to enforce what should be a balanced trading relationship with other countries. We filed a 301 trade petition two years ago, around the violation of worker rights, and just so everybody understands, our own trade act states that the policies of trading partners are unreasonable if they constitute a persistent pattern of conduct and literally these things I cited from these international reports, that denies worker right of association, denies workers the right to organize and bargain collectively, permits any form of forced of compulsory labor, fails to provide minimum age for the employment of children, and fails to provide standards for minimum wages, hours of work and occupational safety and health of workers.

That's our law. The economic theory behind it is that if workers do have the right to organize, they will bargain better wages and working conditions for themselves, and there will be an equitable trading relationship with its partners throughout the world, and this is recognized as a disadvantage. It's unfair and it's illegal.

We have identified in the petition this persistent pattern exists in all these areas. The other findings in the petition I think are very interesting too. You want to talk about what does this mean in terms of a difference or an advantage? From our petition two years ago, we identified that Chinese workers were being forced to work for wages 47 to 86 percent below what they should be.

This is using basic economic models, recognized throughout the world for legitimacy of how to measure this from looking at different types of economies.

I would have to get our economist in here to explain it to you. If the Chinese government did enforce the worker rights and their own minimum wage and workplace standards, manufacturing costs would rise between 12 and 77 percent. We said, okay, 44 percent is the middle. On average, the wages of a Chinese worker were found to be 40 cents an hour. That does not include overtime and payments of all these other things that naturally don't happen in many cases.

The workers' rights of one-quarter of the world's workforce are radically suppressed and labor conditions for the world's skilled and unskilled workers are worsened and domestic and global demand will end up being suppressed.

And excess productive capacity will occur. Everything that we are seeing with the Chinese economy is happening as a result of these illegal subsidies, and in particular these violations of worker rights. We filed this petition because of these overwhelming violations, and frankly when you talk about remedies, our remedy is to petition around this.

Our petition was treated the same way the China currency petition was treated. We were told no, there's a better way, we can jawbone this, we can do it somehow else, and it was rejected. It's been two years. There's a wealth of evidence in reports that I cite in my written comments that show that conditions continue to worsen in China over these events.

It brings pressure to seek cheaper wage as you move around the world, as we work out of this. There's been no action around these issues--

HEARING COCHAIR WESSEL: If you can sum up, please.

MR. BAUGH: Yes. My point is there's been no action around currency. There's been no action on workers' rights. We continue to push on these measures. We continue to seek to have American law address them. We think the WTO has failed us. We will continue to petition. We will continue to work for House Resolution 1498, and other measures that will address these illegal subsidies and worker rights.

Thank you.

Documents referred to in Mr. Baugh's testimony:
http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_04_04wrts/clsinchina2006.pdf
http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_04_04wrts/chinatradeemploymentanddevelopment.pdf

[The statement follows:]

Prepared statement of Robert Baugh, Executive Director, Industrial Union Council, AFL-CIO

Members of the Commission, I want to thank you for the opportunity to testify today.

The AFL-CIO Industrial Union Council is a founding member of the China Currency Coalition. The testimony by Mr. Hartquist, representing the CCC, laid out a strong case on the urgency of our government taking action to address the Chinese government's manipulation of its currency. Currency manipulation is part of a broader pattern of illegitimate subsidies by the Chinese government affecting America's manufacturing industries. I will focus on these and most specifically — and most specifically on the continuing workers' rights abuses in China and their impact on American workers.

The litany of China's failures to meet its trade obligations is extensive—loans from state banks to industry that are never repaid, extensive currency manipulation, illegal dumping, rampant intellectual property violations, environmental degradation, and massive human rights, religious, and workers' rights abuses. Compounding these problems is a complete lack of transparency within China. It remains difficult and dangerous to obtain information on workers' or human rights problems, and the banking and financial systems are closed to outsiders. Additionally, the government of China implements stringent regulations making it a criminal act to reveal information deemed to be a "state secret." Unfortunately, "state secret" seems to apply to almost anything, including reporting on labor disruptions.

This hearing is particularly important, as Chinese President Hu plans a visit to Washington, D.C., later this month. While currency manipulation appears to be on the agenda for discussion at that meeting, we urge policymakers and the Administration not to neglect the ongoing humanitarian and economic issues raised by the Chinese government's repressive policies toward its own workers.

Our country is on a dangerous and unsustainable path, one that encourages and rewards irresponsible corporate policies, while leaving American workers, family farmers, domestic producers, and communities devastated. Growing debt in both the private and public sectors is powering American consumption, which in turn is driving global growth. This debt-driven growth masks underlying weaknesses and cannot be a sustainable solution.

The current situation serves the short-term interests of the multinational corporate elite around the globe, but is already failing working families here and abroad.

Falling real wages, negative savings, and growing inequality in the United States are clear signs that working families are paying the price today for these failed policies. We are mortgaging our children's future to pay for unsustainable debt and consumption today. And if we do not take dramatic steps soon to reverse this unsustainable trend, then the resulting collapse could be devastating to global economic prosperity and stability.

Trade Deficit and Job Loss

The U.S. bilateral trade deficit with China hit $201 billion last year. This is the largest bilateral trade deficit between any two countries in history. The Economic Policy Institute estimates this trade deficit has cost us 410,000 jobs and job opportunities in the past two years alone.

It is a sad but true fact that empty cargo containers are our largest export to China.. Our imports from China continue to outstrip our exports by more than five to one, making this by far our most imbalanced trade relationship with any major trading partner. Meanwhile, the United States has lost almost three million manufacturing jobs since 2001.

While many factors contributed to this devastating job loss, it is clear that the Chinese government's manipulation of its currency, violation of international trade rules, and egregious repression of its citizens' fundamental democratic and human rights are key contributors to an unfair competitive advantage. The Chinese government is flouting its international obligations, and no one is holding them accountable.

Unfortunately, to date, the U.S. government has failed to act effectively to stem the job losses resulting from the burgeoning U.S. trade deficit with China. The Bush Administration has refused concrete action to ensure that the Chinese government lives up to its international obligations on trade, currency manipulation and human rights. President Bush has denied American businesses and workers the import relief they are entitled to under the law, and he has taken positions at the World Trade Organization (WTO) that will only worsen our trade relationship with China.

Over the past five years, China has repeatedly and consistently failed to comply with WTO rules. The Bush Administration, rather than take advantage of the WTO's formal dispute settlement mechanism to address these violations, has preferred to rely on prolonged discussions and informal consultations in its failed attempts to guarantee China's compliance. Nothing has been accomplished.

Illegal Subsidies and Transparency

Currency manipulation may be the most visible violations of trade law by the Chinese government but there are many other forms of illegal subsidies. The violations of workers' rights are the most egregious and costly of all.

Failure to Act on Currency Manipulation

Since last summer the Chinese yuan is no longer technically pegged to the dollar. However, China's currency has barely moved from the rate established in 1994, and it is estimated to be undervalued by as much as 40 percent. This gives China an enormous competitive advantage in the U.S. market and creates an inherently unstable and unsustainable situation.

The Chinese government must allow the yuan to reflect underlying economic and market forces. It must revalue the its currency to reflect it true value, then adopt flexibility for the yuan and cease its accumulation of U.S. dollar reserves. While the Chinese government's reluctance to take this action is perhaps understandable, the Bush Administration's failure to act more forcefully in this regard is not.

We believe Congress should take action by passing HR 1498, the Hunter-Ryan bill, and use its mechanisms to send a clear message to the Chinese government that the current situation is unacceptable and will not be tolerated. It is now clear that simple diplomacy and lackluster negotiations have failed.

China Misrepresents Actual Trade Surplus Figures

The China Currency Coalition in a 2005 study found that China's global surplus is more than 325 percent higher than China's trade statistics claim, according to its partner trading data.

China is "hiding the ball" by deliberately reporting incorrect trade statistics. The China Currency Coalition maintains the figure reported by import partners more accurately reflects China's net income from trade. The problem of incorrect trade statistics underscores a much larger transparency problem across government agencies.

Free Money: China's Non-Performing Loan Practice

The deliberate extension of billions of dollars in non-performing loans by China's central banks has given China another unfair advantage. Simply put, state banks make loans to industry with little expectation those loans will be repaid. Most of these free loans have been transferred to four government-owned asset management corporations (AMCs), so the government budget, rather than the banking system, will bear the costs.

According to IMF reports, bad loan ratios for the major commercial banks in China have fallen from about 24% of loans in 2002 to about 13% in September 2005. This apparent decline results from questionable accounting practices—they only report the bank share of the debt, and not the government-owned share.

Due to the lack of transparency in the Chinese banking and financial system, it is difficult to calculate the total amount of these illegal non-performing loans. However, IMF economists reported in 2005 that these bad loans may have amounted to as much as 30 percent of China's GDP in 2003.

It is further estimated that 40% of all loans in 2002 were non-performing, and that previous non-performing loans (some now in the form of government debt) might total $400 billion.[i] Other estimates place the figure higher, at a whopping $650 billion.[ii]

Either way, it is clear that over the past decades, the Chinese have illegally subsidized business development through non-performing loans—unfairly subsidizing industry to the tune of hundreds of billions of dollars.

Direct and Indirect Subsidies: Free Land, Labor and Facilities

Non-performing bank loans are just the tip of the iceberg when it comes to illegal subsidies by the Chinese government. Here too transparency is an issue because it is difficult to obtain accurate and complete data about these practices but it is clear from the information available these practices are widespread.

The U.S. government is aware of these violations, and our trade delegation in Geneva has actively used the WTO Transitional Review Mechanism (TRM) to scrutinize China's ongoing compliance with its WTO commitments and obligations. Last fall the U.S. used the TRM to question the Chinese government's failure to provide a comprehensive accounting of its subsidy program. The Chinese government continues to administer programs that are thought to be illegal. The U.S. government also questioned the Chinese government's Northeast Revitalization Industrial Policies, an industrial policy designed to help companies located in the north-eastern region of the country compete in global markets. Among other things, the policy provides export credits and carries out strategic restructuring of key enterprises in the oil, petrochemical, iron and steel, automotive, shipbuilding, and aircraft products manufacturing sectors.

The concerns over China's industrial policy and illegal subsidies are well placed. Senator Joseph Lieberman in an article, "The U.S. Must Act Quickly to Maintain Vital Defense Technology," outlined how illegal subsidies and industrial policy come together to capture manufacturing and technology in one critical industry:

> "The migration of research and design capabilities to China is of particular concern. Chinese policy has resulted in a sharp upsurge in construction of fabrication facilities in that country, with plans for a great many more. To ensure that they develop the ability to build the next-generation fabrication facilities, the Chinese central government, in cooperation with regional and local authorities, has undertaken a large array of direct and indirect subsidies to support their domestic semiconductor industry …

> The immediate and most powerful incentives for a highly leveraged industry are the direct and indirect subsidies, including the infrastructure needed for state-of-the-art fabrication plants, offered by the government. For example, the Chinese central government has undertaken indirect subsidies in the form of a substantial rebate on the value-added tax (VAT) charged on Chinese-made chips. While many believe this is an illegal subsidy under the General Agreement on Tariffs and Trade (GATT) rules, the impact of the subsidy on the growth of the industry may well be irreversible before—and if—any trade action has taken place. China also systematically undervalues its currency, often by as much as 40 percent, which gives its goods a major price advantage. This practice also may violate trade rules.
>
> The development of special government-funded industrial parks, the low costs of building construction in China as compared with the United States, and China's apparent disinterest in the expensive pollution controls required of fabrication facilities in the United States all represent further hidden subsidies. … These actions reflect a strategic decision by the Chinese government to capture the benefits of this enabling, high-technology industry and become a monopoly supplier, and thus control pricing and supply levels."

The cost of construction is also underwritten by continuing violations of labor standards. The April 4, 2006 report by the International Confederation of Free Trade Unions for the WTO General Council Review of the Trade Policies of the Peoples Republic of China found that "over 94 million private sector migrant workers are owed more than $100 billion yuan in back wages … the problem is most severe in the construction industry, which accounts for 70 percent of the total amount owed."

Lack of Environmental Regulation Lowers Cost of Production

Another unfair competitive advantage for manufacturers in China comes from lax environmental regulations and failure to enforce existing laws. Because China does not effectively regulate pollution, dumping, and emissions, corporations often fail to effectively employ even basic environmental protections. Cheaper goods, ruined communities, and sick workers are the result.

According to the Environmental Sustainability Index, an initiative by the Yale Center for Environmental Law and Policy (YCELP) and the Center for International Earth Science Information Network (CIESIN) of Columbia University, in collaboration with the World Economic Forum and the Joint Research Centre of the European Commission, China ranks a lowly 133 out of 146 nations. Its environmental sustainability rating, at 38.6 percent, is just below Iran, and just above Tajikistan.

A recently published study from the *Environment, Science, and Technology Journal* entitled, *Modeling Study of Air Pollution Due to the Manufacture of Export Goods in China's Pearl River Delta*, found that exported goods from China are cheaper to produce due to low or non-existent emission controls.

According to David Sheets, a policy analyst at Argonne National Laboratory and lead author of the report, "We in the West take advantage of cheap goods manufactured in China and other developing countries, and one reason they're cheap is because there aren't a lot of environmental controls. So we get the benefits of the cheap goods, and they absorb the air pollution; there's something not quite right about that."

<u>Violations of Workers' and Human Rights</u>

In addition to the unfair competitive advantage gained through currency manipulation and illegal subsidies, the Chinese government's systematic repression of fundamental workers' rights is a key contributor to the undue advantage Chinese exports enjoy in the U.S. market. Chinese workers' most basic rights are routinely repressed, and they do not enjoy the political freedom to criticize, let alone change, their government.

Enforcement of wages, hours, and health and safety rules is lax or non-existent in many areas of the country. These abuses allow producers in China to operate in an environment free of independent unions, to pay illegally low wages, and to profit from the widespread violation of workers' basic human rights. For example, Chinese mineworkers face conditions that rival or surpass some of the worst labor abuses in American history. Research indicates that more than 10,000 people die in Chinese mines each year. Coal mines in China may be the most dangerous places in the world to work. But unlike American mineworkers, Chinese mineworkers are denied the right to organize and bargain collectively.

Rates of illness and injury have never been higher in China's manufacturing sector -- as officials of China's own Work Safety Administration conceded as recently as February, 2006.[iii] Aggregate unpaid wages have risen to record levels, setting off thousands of illegal demonstrations, labor shortages, and increased child labor – as adult workers increasingly refuse to accept such injustice. Workers who merely petition for payment of their wages are increasingly met with violence by security police and other local officials.

There are as many as ten to twenty million child workers in China – from one-eighth to one-quarter the number of factory workers. The problem of child labor has increased in recent years.
China's minimum working age standard is very widely violated, and the Chinese government does little to enforce the standard. As the U.S. State Department stated in its 2005 Report on China, "The government continued to maintain that the country did not have a widespread child labor problem."[iv] As reported in CSR – Asia Weekly last November local officials rushing to compete for manufacturing investments local are reticent to enforce child labor regulations.

China oversees a system of forced labor, not prison labor. The precise number of forced prison laborers is unknown but estimates range from 1.75 million to 6 million and higher.[v] Independent researchers, the Congressional-Executive Commission on China, and the U.S. House of Representatives confirmed that goods produced in China by forced labor continued to be exported to the United States in 2005.[vi] In its 2005 resolution condemning China's forced labor, the House of Representatives detailed the appalling working conditions, hours of work, and that the "Chinese Government has continuously encouraged the export of goods produced through the Laogai prison system and relies on forced labor as an integral part of its economy.

Chinese policies amount to a deliberate and artificial suppression of wages below what a freely bargained wage would be, and even below what would be efficient in the Chinese context. This exploitation impacts American workers and domestic producers, as well as those in other developing countries, and artificially lowers the price of Chinese exports in the U.S. market.

In China, the result has been "labor shortages," wildcat strikes, and massive protests. According to Time Magazine ("Inside the Pitchfork Rebellion," by Hannah Beech), "Violent local protests are convulsing the Chinese countryside with ever greater frequency-- and Beijing has proved unable to quell the unrest. By the central government's own count, there were 87,000 'public order disturbances' in 2005, up from 10,000 in 1994."

That is an average of 238 protests every day last year.

President Bush did not demand any specific improvements in human rights when he met with China's President Hu in the summer of 2003. Instead, the Bush Administration has only engaged in an ambiguous and ineffective "cooperative dialogue."

The Administration's failure to take concrete actions on human rights and workers' rights in China allows rampant violations to continue. Workers in China, the United States, and around the world pay the price for this inaction, while companies producing in China enjoy the profits.

ICFTU Report to WTO on China's Failure to meet Labor Rights Commitments

The People's Republic of China has ratified four of the eight, core ILO labor Conventions. In view of restrictions on the trade union rights of workers and continuing problems with discrimination, child labor and forced labor, major policy changes are required to comply with the commitments WTO

Members have accepted in Singapore and at Doha, in the WTO Ministerial Declarations over 1996-2001, and in the ILO Declaration on Fundamental Principles and Rights at Work.

- China has not ratified the ILO core Convention on the Right to Organize and Collective Bargaining, nor the Convention on Freedom of Association and Protection of the Right to Organize. Workers are deprived the right to organize freely, to form independent trade unions, and to engage in collective bargaining. The right to strike is not recognised. The state and government use a variety of anti-union tactics to control workers, including repression of industrial action and imprisonment of those fighting for workers' rights.

- China has ratified the core ILO Convention on Equal Remuneration and the Convention on Discrimination. Discrimination is prohibited by law but does occur in practice. Legislation requires equal pay but wage differences continue to exist between men and women and among different ethnic groups.

- China has ratified the ILO core Convention on the Worst Forms of Child Labor and the Convention on Minimum Age. Child labor, however, remains a problem in China, in particular in rural areas and in some industrial sectors, where regulations are applied lightly and where children, thus, are exposed to hazardous working conditions.

- China has not ratified the Convention on the Abolition of Forced Labor or the Convention on Forced Labor. Forced labor exists in such forms as prison labor, legal punishment in the form of "re-education-through-labor", and forced prostitution of women.

Chinese policies amount to a deliberate and artificial suppression of wages below what a freely bargained wage would be. This exploitation impacts American workers and domestic producers, as well as those in other developing countries, and artificially lowers the price of Chinese exports in the U.S. market.

Workers' Rights Section 301

Over two years ago, the AFL-CIO filed an unprecedented petition with the United States Trade Representative under Section 301 of the Trade Act of 1974. The petition asked the Trade Representative to take action to end the Chinese government's repression of the human rights of its factory workers.

It marked the first time in the history of Section 301 that a petition invoked the violation of workers' rights as an unfair trade practice, although it is common for corporations or the government to use Section 301 to challenge commercial unfair trade practices, such as illegal subsidies or violations of intellectual property rights.

Section 301(d)(3)(B)(iii) of the Trade Act provides that acts, policies, or practices of a trading partner are unreasonable if they constitute "a persistent pattern of conduct" that –

(I) denies workers the right of association,
(II) denies workers the right to organize and bargain collectively,
(III) permits any form of forced or compulsory labor,
(IV) fails to provide a minimum age for the employment of children, or
(V) fails to provide standards for minimum wages, hours of work, and occupational safety and health of workers.

The petition showed that the Chinese government was engaged in a "persistent pattern" of denying the fundamental rights of its factory workers. Second, it demonstrated that China's violation of workers' rights artificially reduces wages and production costs in China and, as a result, displaces hundreds of thousands of manufacturing jobs in the United States.

The petition also showed that workers in China are being forced to work for wages 47 to 86 percent below what they should be, often as bonded laborers, with few workplace health and safety protections and no right to join or form free trade unions. The cost-advantage of this worker repression is staggering. If the Chinese government enforced workers' rights and its own minimum wage and workplace standards, manufacturing costs there would rise between 12 and 77 percent, or an average of 44 percent.

This unfair cost advantage, continues to add to the stunning bilateral trade deficit with China,.
Under the terms of Section 301, we argued that this clearly "burdens and restricts" U.S. commerce.

In the model of development embodied in section 301(d), the global integration of labor markets, capital markets, and markets in goods and services is not intrinsically a bad thing. If workers' rights are vigorously enforced, then the impoverished and underemployed – whether in China, India, Indonesia, Mexico, or the United States -- may improve their standard of living and generate new domestic demand in a virtuous cycle of equitable development, while providing new markets for overseas investors and workers, including those in the United States.

If, however, the workers' rights of one-quarter of the world's workforce are radically suppressed – as they in fact are, in China -- then labor conditions for the world's unskilled and semiskilled workers are worsened; domestic and global demand is depressed; excess productive capacity is created; and a path of inequitable, unsustainable development is promoted.[vii]

Failure to address the systematic, egregious, and institutionalized repression of workers' rights in China costs hundreds of thousands of good jobs here, creates conditions of desperation and exploitation in China, and fundamentally alters the nature of global labor competition in the rest of the world.

The AFL-CIO's 301 petition sought to ensure that our government would give this issue the priority it deserves in its economic dialogue with the Chinese government.

China Denies Workers' Rights

The overwhelming evidence that the Chinese government denies the workers' rights covered by the Section 301 petition in 2004 has only become stronger in the two years since the case was filed. The petition amassed evidence from the U.S. State Department, the International Labor Organization (ILO), labor unions, academics, newspaper accounts, and human rights groups. The AFL-CIO and other organizations continue to track the Chinese government's violations. Rather than showing signs of improvement, all reports indicated conditions are worsening.

- ***China denies freedom of association and the right to bargain collectively*. The Chinese government relentlessly represses attempts to organize unions that are independent of the government-controlled All-China Federation of Trade Unions (ACFTU). The ACFTU is officially and legally subservient to the Communist Party and to local officials who profit from export enterprises. Workers who attempt to strike or organize unions independent of the ACFTU have been arrested, imprisoned, beaten, and tortured. Even workers who have spoken out against corrupt managers, who have had the temerity to demand that wage arrears be paid, or who have attempted to publicize workplace problems have been subject to severe reprisals and arrest.**

- ***Conditions of forced labor are widespread*. Many of the workers in China's export sector are temporary migrants from the countryside, who work under a repressive system of internal controls. Factory workers arriving from the countryside must pay substantial fees to local government officials and to employers to obtain the residence and work permits required by the "hukou" system, often leaving them heavily indebted. They lose their deposit if they quit without the employer's consent. In addition, employers frequently withhold one month to several months' pay, which workers lose if they quit or assert their rights. They are thereby essentially turned into bonded laborers who cannot leave their employment without incurring large and disproportionate penalties. The wages, conditions of work, and hours often turn out to be quite inferior to what is promised upon arrival, meaning that workers have clearly not entered into a free labor market, with fairly enforced rules.**

- ***China does not enforce its own laws with respect to minimum wages, maximum hours, and workplace safety and health*. Many manufacturers in China, including multinational corporations, pay their workers much less than the minimum wage standards set by the central and provincial governments. It is apparently common for companies to keep double and triple sets of books, to hide this practice. Workplace safety and health practices are atrocious, and China has the highest rate of industrial deaths and accidents in the world. Government officials simply do not enforce their own laws on wages, hours, and safety and health.**

The AFL-CIO's petition did not challenge China's right to compete in the global economy on the basis of low wages. It is natural for a developing country with an excess supply of poorly educated rural workers to have low wages. We fully understand that even if China fully enforced its workers' rights, the wage gap between Chinese and American workers would not disappear. But it would surely narrow. The AFL-CIO challenge was specifically targeted to the *incremental* cost advantage that comes from the brutal and undemocratic repression of workers' human rights. That increment was then and remains today illegitimate advantage under universal norms of human rights. And it is illegitimate under U.S. trade law as well.

Workers and Currency: No Action Then, No Action Now

Between China's brutal repression of workers' rights and its continuing currency manipulation, the Chinese government has a one-two punch that is destroying American manufacturing jobs and critically endangering our national security.

While the Bush Administration conceded there were serious concerns with regard to China's workers' rights abuses, it nonetheless denied the AFL-CIO's petition. Seven months after the President rejected the AFL-CIO's first petition, the Chinese government abruptly cancelled an international conference on the monitoring of workplace conditions.

In its 2005 Annual Report, the Congressional-Executive Commission on China (CECC) concluded "the Chinese government has avoided discussions with the international labor community on Chinese workers' rights." The CECC also found in 2005 that:

> "The Commission finds no improvement overall in human rights conditions in China over the past year…. The Chinese government does not recognize the core labor rights of freedom of association and collective bargaining. The government prohibits independent labor unions and punishes workers who attempt to establish them. Wage and pension arrears are among the most important problems that Chinese workers face…Chinese workers continue to struggle to collect wages and benefits because relevant agencies do not enforce the regulations. Workplace health and safety conditions are poor for millions of Chinese workers…Forced labor is an integral part of the Chinese administrative detention system, and child labor remains a significant problem in China, despite being prohibited by law…."

Similarly, the State Department's 2004 Country Report on Human Rights in China concludes "The [Chinese] Government continued to deny internationally recognized worker rights, including freedom of association" – the identical conclusion reached in the State Department's 2003 Report.

The just-released 2005 State Department Country Report on Human Rights in China is much the same, finding that China denies basic worker rights, including freedom of association, workplace health and safety, payment of wages, rights against forced labor, and rights against trafficking in children. Peaceful labor protestors are subject to police violence, imprisonment, and torture. This report by the Administration itself concedes that these fundamental facts have not changed since the President's assertion in 2004 that he would undertake measures to remedy China's noncompliance. According to the State Department, regulations aimed at suppressing autonomous labor organizations grew harsher in 2005.

Following the denial of the Section 301 workers' rights petition, the China Currency Coalition, an organization representing business and labor, including the AFL-CIO, submitted a Section 301 petition on Chinese currency manipulation on September 9, 2004. The Administration denied the petition the day it was filed. A third 301 petition, again addressing the currency issue, was filed by 35 United States Representatives and Senators. It too was summarily rejected.

In all instances, the Administration's excuse was an ambiguous response that some unspecified action would be taken. The *modus operandi* has been and remains to talk little and do less. The President consistently sides with multinational corporate interests that manufacture in China over American working families and America's manufacturing industries.

The results in the U.S. have been devastating: hundreds of thousands of lost jobs, countless bankrupt businesses and ruined communities. Unsafe and exploitative working conditions remain for uncounted Chinese workers.

Time to Act

The administration has clearly abdicated its duty to protect American workers and industry. The onus now falls upon Congress and the U.S. China Economic and Security Review Commission to help guide our nation to swift action. We simply cannot afford another year of inaction and empty promises. We cannot afford another year of watching working conditions in China worsen and good jobs continue to leave the United States.

The AFL-CIO will continue to support measures to address currency manipulation, such as H.R. 1498, the bipartisan Ryan-Hunter China Currency Act of 2005; as well as S.295, the Schumer-Graham bill, which would impose a 27.5 percent tariff on Chinese goods if the Chinese government fails to revalue its currency in a timely fashion. And we will support legislation to address other illegal subsidies raised in this testimony. Most of all we will continue to work in every forum possible to improve workers' rights in China.

The AFL-CIO remains committed to fighting for America's working families and America's manufacturing industries.

Thank you for having me here today and thank you for the important work you do.

PANEL IV: Discussion, Questions and Answers

HEARING COCHAIR WESSEL: Thank you. I believe we'll have time for probably two rounds of questions. Chairman Wortzel.

CHAIRMAN WORTZEL: I appreciate the three of you coming today; thanks a lot for your testimony. Fred, I've heard a number of free market economists make the argument that the Chinese purchase or ownership of a significant amount of U.S. Treasuries ought to be viewed as an offset to the trade imbalance, and that we shouldn't worry about a trade imbalance.

That they've got a lot of money over here and it comes back into the U.S. economy and that that trade imbalance is just an argument made for protectionist purposes. Yet, you made the statement, if I heard you right, that you'd like China to sell of those Treasuries.

Two questions then. Is there a relationship between the trade imbalance and the Chinese purchase or holding of those U.S. government Treasuries and securities? And second, why do you want them to get rid of it? And then how do we address the trade imbalance? Or should we?

DR. BERGSTEN: As I think I tried to say in my statement, the trade imbalance and the Chinese purchases of Treasuries are obverse sides of the same coin. The Chinese run their trade surplus in large part because of an undervalued currency.

They maintain the undervalued currency by direct official intervention in the exchange markets. There is huge amount of foreign capital flowing into China. If the Chinese currency were a floating unmanaged exchange rate, the Renminbi would have strengthened greatly in value before now, long before now, by large amounts.

But the Chinese buy those dollars at a fixed price and that keeps the inflow of dollars from pushing up the value of the Renminbi, reducing their competitive position, and thereby reducing their trade surplus.

So the two are flip sides of the same coin. Chinese take those dollars that they bought through the intervention process and put them in U.S. Treasuries and the circle is complete.

Now, as I said in my remarks, there are both benefits and costs to the U.S. from that arrangement. And in part, how you balance those depends on your time horizon and in part depends on how sustainable you think that process is.

In the short run, the U.S. is like an individual consumer getting product on his credit card with nobody calling his balance. So you can consume more. You can indeed in this case consume more than you produce. You can, quote, "live beyond your means," and as long as it goes on, it's enjoyable.

On their side, the Chinese love it too. As I said, it's an off budget export subsidy, so they get jobs and development and rapid growth and all that. So there is what we called in some of our studies a global co-dependency syndrome, where both sides of this imbalance actually learn to love the imbalance.

That is one reason why it's so difficult to get rid of it, because both sides in the aggregate actually like it. Now, if you want to get a little more sophisticated, you can say whether you ought to like it or not depends in the short-run on the state of your economy.

Comment was made, I understand that, by Mr. Baugh that the U.S. lost all these jobs because of the undervaluation of the Renminbi. And it's certainly true that we've lost jobs in certain sectors because of that.

But the U.S. economy, by almost any calculation is at full employment. We've been creating lots of jobs. We've been having rapid economic growth. Incomes are not up as much as I'd like. There are all sorts of problems with distribution, but on balance the U.S. all through this period when our trade deficit has been large and rising has been growing very nicely, certainly by the record of our previous 30 years, certainly compared with all other big industrial countries in the world.

Indeed, in the late 1990s, unemployment dipped below four percent for the first time in 40 years. Now it's under five, not as good, but not bad. So it's a little hard to say that net we've had job loss--net, I'm stressing--because of all this. Clearly redistribution. Some sectors have lost. Some sectors have gained.

So that's in the short run. When your economy is growing rapidly at full employment, particularly if you've got inflation pressure like we had in the 1990s, then you can actually make a case for having an overvalued currency, the dollar, and when the Clinton administration talked about the virtues of a strong dollar and defended a strong dollar policy, there was at least an argument in their favor. I disagreed with it at the time, to be honest, but they had an argument in their favor, that the flow of imports was holding down inflation, that the foreign investment in the dollar was holding down interest rates, and that was keeping our economy in the aggregate--I keep stressing in the aggregate--going more strongly.

If your economy is weak and you've got high unemployment and slow growth, then obviously a currency overvaluation is a bad thing because it's exacerbating the problem, but that's not us, at least not right now, and really hasn't been for most of the last ten years.

However, to me, as I said before, but I'll underline it, the real problem is the unsustainability of the situation because I don't believe that imbalances of anything like this magnitude, particularly when they're on a trajectory to keep getting bigger, can be maintained for any indefinite period of time.

But, as I said, as some of you know, two or three years ago, the dollar did come down a lot in '02, '03, a bit in '04, but there's certainly been no hard landing, no crash, no calamity. So those who say, well, let's just sit back, enjoy it, live with it, at least for awhile longer, have some vindication for their views, to be intellectually honest.

Now, as I said, I think at the end of the day, that's a fool's paradise that we're building up to a situation where either or both of two unsustainabilities hit us.

One is the world tires of putting in the $7 billion per day of capital that we are now dependent on. We must attract $7 billion of foreign capital from the rest of the world every working day to finance this current account imbalance and our own outward foreign investments.

It's not as if we suffer only if the world draws down the $12 trillion of dollar assets already floating around the world. It's just if the daily inflow dropped from $7 billion to say $3 or $4 billion, it's still a lot of money, that wouldn't be good enough because we need seven, and so prices would change, maybe radically. The dollar exchange rate would go down, our inflation would go up, our interest rates would go up, our economy could be in the tank.

I think it's simply a matter of time until that happens, so it's very unsustainable. Secondly, the domestic politics here. As I mentioned in the two previous historical cases, the Nixon case in '71, the Reagan-Baker case in '85, it was the domestic political unsustainability, and I'm looking at Mr. Wessel because his boss at the time, Congressman Gephardt, was much involved in that, the domestic politics break, and the sectoral effect that Mr. Baugh talked about, and the job losses in particular sectors become so costly to those industries and to American labor, that they're just not willing to take it anymore.

Since you can, justifiably, as we are today, pointing to the economic irrationality of the currency misalignments and even sometimes, like with China now, overt government intervention to keep things from getting to a more economically viable position, then you have justification for acting against it.

So either or both of those two unsustainabilities suggest to me that we ought to be taking preemptive action to head this off. I say to my friends in the administration, you're willing to take preemptive action in certain cases that may or may not have been so compelling. Here's a case that I believe is compelling, and I sure wish you'd take preemptive action on that.

HEARING COCHAIR WESSEL: Thank you. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Do you mean we should invade China?

DR. BERGSTEN: That's not the preemptive action I had in mind.

COMMISSIONER BLUMENTHAL: Thank you very much for your testimony. For all three of you to put on your predictive hats: We have a state visit and here we're calling it just a visit of the two presidents, and this is obviously going to be an issue.

We're seeing a lot of scene setters and certainly, as you mentioned, Dr. Bergsten, the domestic politics here are such that there's going to be tremendous amount of pressure on our president to have a win on the currency issue.

Hu Jintao, I think, faces a lot of dilemmas in the sense of, as you all mentioned, that you revalue the currency and what do you do about the fact that you need 100 million new jobs in the short-term, so he's going to face a lot of dilemmas in terms or providing that sort of win. So if you could, all three of you, predict as to how this is going to come out in the meeting that's coming up, I'd greatly appreciate it. I know it's a tough thing to do, but I'm asking you to do it.

DR. BERGSTEN: The Chinese strategy, if you can call it that, has been to get away with doing as little as possible, but keep the dogs at bay. Mr. Hartquist mentioned the so-called currency reform of last summer, which amounted to a two percent revaluation and an alleged widening of the margins that have not been exploited since that time.

So it really was very little. However, it won some plaudits in some quarters in this city and in this country, and bought them, at least, a few months in terms of reaction from either the administration in its periodic foreign currency reports and from the Congress.

I actually would have thought they'd have done a little something more along that line by now. They have let the rate float up just the tiniest bit within these wider margins, maybe another percent of movement against the dollar over the last couple of months, bringing to a cumulative total maybe three percent against the dollar over the last nine months since they changed the system so-called back last July, but that of course is minuscule compared to the reevaluation needed.

Mr. Hartquist said 40 percent. I'd put it anywhere between 20 and 40, different methodologies. But in any event, the three percent is a tiny share of what needs to be done.

So I would have thought they would have done more by now. They may let the rate float up a little more before the president gets here. The other side of it is, is that the Chinese like to avoid appearing to move in response to foreign pressure, and always trumpet that principle loudly.

So I would have thought the closer we get to the visit, the less likely they would be to move. So it may be that in this upcoming meeting, we've had no further movement, and I think you're right, that will lead to a lot of difficulty.

Let me just make one other comment because it's important for the whole debate. You mentioned rightly that the Chinese worry about their unemployment and adversely affecting that by letting the currency go up and bring the trade surplus down. The point was, to state the obvious, that their trading surplus is artificially increased by the undervalued currency, and that's been a job subsidy as I characterized it before.

So some of the jobs that they now have are subsidized in that sense, but the practical point is that as they phase in, as inevitably will have to happen, a stronger currency, they will have to simultaneously phase in an increase in domestic demand to create more jobs and offset the reduction in total demand for their output implied by the declining trade surplus.

That's a very important point. Now fortunately, the Chinese have a strong fiscal position, and they have huge domestic needs, particularly in the social area, for health care, health insurance, pensions, education, reform. All those things, which used to be provided in large part by the state-owned enterprises, have diminished drastically as the state-owned enterprises have been reformed.

Fewer than 20 percent we're bad enough. We have 40 plus million people who don't have health insurance. In China, fewer than 20 percent of the population has any health insurance. Fewer than 20 percent have any pensions, and even the peasants until very recently have had to pay for primary education, so there's a huge need for the Chinese government to increase its spending dramatically on those programs.

That's necessary for social reasons and to limit the amount of disruption and political disarray they've got throughout the country. From a macroeconomic standpoint, that's exactly what the doctor ordered anyway, an increase in domestic consumption spending, in this case, via government, in the first instance, to inject added demand into the economy from the domestic side, so that they can accept a reduction in external demand as the trade surplus comes down as a result of a stronger currency without adversely affecting overall growth and the total level of employment.

So we're talking here about five-year, at best, five-year transition period, phase-in period, as they would phase in a stronger currency and more domestic spending.

COMMISSIONER BLUMENTHAL: Do you see them going in that direction?

DR. BERGSTEN: Yes, yes, they've explicitly said they intend to go in that direction, in a way, as they've explicitly said they intend to move to a more flexible currency.

MR. BAUGH: And they'll say that again.

DR. BERGSTEN: The issue, of course, the issue of course is when? The Chinese tactic seems to be to accept the goal that is suggested to them, but then not to do much about it for a prolonged period of time. In the case of the domestic spending, I think they actually do intend to do something about it because the result of not doing it is social unrest, and a lot of the things that the governing Communist Party worries about is disruption of their control via all this unrest which is happening widely around the country, widely documented. A lot of it in response to the inadequacy or unavailability of adequate health care and pensions, et cetera.

So I think they will be increasing their spending rapidly in those areas. The fact is they don't spend very much on it at all now, so even big percentage increases don't amount to much in total economic terms, but over a five-year period, I think they will do a lot on that front.

So to me the least of the worries with China, given its growth rate, its prospects, is that they'll be able to maintain rapid overall economic growth even in the face of a declining currency. In the case of a strengthening currency, keep in mind that their dollar peg back in the 1990s meant that they rode the dollar up.

They rode the dollar up 40 percent over a six-year period, and they grew at ten percent all through there, so it hardly decimated their economic prospects. I think the same thing would apply again, particularly since they've got this pent-up demand for domestic spending increases that I think are really already on their drawing board and will be implemented over the next few years.

MR. BAUGH: I'm willing to bet everything he said. Basically we as the CCC group has met over the last two years, we've predicted every one of these scenarios. We'll accept promises that we're going to be more flexible and we really mean it this time. There might be some slight movement in the currency, and we will buy off another Treasury report, that the Treasury's promise will be more critical this time, but not pull the trigger to say to take action.

I think Skip verified all the people that are part of our coalition who have negotiated directly with the Chinese--the guy that's on his staff that does this negotiating of these original agreements, everybody tells us over and over, they won't take you seriously unless they think you're really going to do something. And they don't believe we're really going to do something, and there is this sick mutual dependency that Dr. Bergsten points out here and a refusal to move.

MR. HARTQUIST: I absolutely agree, and Commissioner, the gentleman that Bob is referring to is my colleague Bob Cassidy, who was a lead U.S. negotiator for USTR when China joined the WTO. He negotiated the accession agreements. Bob understands, I think, the political psyche of China and he understands the economic pressures that the Chinese have against them.

It's his view, and I concur completely, that they're frozen in time. They're not going to make an announcement. Let me put it this way. It would be entirely uncharacteristic of the Chinese government to make a significant announcement at this meeting with President Bush. Most summit meetings of this sort, world leaders will come together and they'll have something to say, and it will be prenegotiated before the event occurs just like at the G-7 summit meetings, the G-8s, and so forth. Chinese typically do not do that, and it's our view that the only thing that would cause them to really take this seriously and move is the fear that the United States government would permit countervailing duty cases, based upon exchange rate manipulation, against the Chinese because then we would be able to show the injury that is occurring. We would be able to prove that this is a subsidy, as we absolutely believe is the case, and there would be some enforcement authority to deal with the damage that is being done to our economy. Without that, I don't think there is any hope for any significant change.

HEARING COCHAIR WESSEL: Let me ask some questions about the tipping point. Chairman D'Amato and I served on the Trade Deficit Review Commission in 1999 and 2000, and I would agree with you, as our commission did, that the trade deficit is unsustainable. Six years later it's still unsustainable. The question is, when do we reach a tipping point?

We see a dramatic build-up in reserves and holdings of our T-bills and other financial instruments. We've seen increasing efforts to recycle some of those dollars here in our market, some very low profile transactions, some high profile, Lenovo last year, CNOOC, and now the purchase of 16,000 computers by the State Department that seems to be flying under the wire.

Fred, you were involved as a policy advocate during Japan's threats to potentially sell off some of our T-bills in the 1990s. Where are we in terms of the tipping point? What kind of leverage does China have? We've just seen the second, if I remember, booting down the field of the potential Senate vote on the Schumer-Graham bill.

Have we lost leverage? Are we in a point where all we can do is name and shame, that actually taking action is something we can no longer do?

DR. BERGSTEN: No, I don't think so. I don't think there's really any significant risk that China or Japan, the other big holder of U.S. financial assets, would sell off their dollars to any large extent. It would obviously shoot themselves in the foot in two senses: (a) it would drive down the value of their remaining hundreds of billions of dollars of assets.

But, moreover, it would drive their own currency up and that's what they don't want. The whole issue here is that they're buying dollars in order to keep their currency from rising. If they turned around and dumped all those dollars, then it would have the reverse effect and that's the last thing they want. So I think that's the last thing we have to worry about it.

Now, there's an intermediate case which is the Chinese or some dollar holder would sell their dollars, not for their local currency, but for euros. And the people that would hate that would be the Europeans, because it would drive up the value of the Euro against the dollar.

I always twit my European friends who have talked about wanting to create the new global currency, the Euro, but whenever they hear the thought that the Chinese or somebody might actually buy some Euros in return for dollars, they're horrified and tell the country involved please to cease and desist.

So I don't think that's likely to happen, and so in thinking of it in kind of zero sum or combative terms, I don't think we have any significant fear on that count.

That's point one. Point two, I think you put two things together that I like to keep separate, which is the two sources of unsustainability of the current account deficit. One is that financial risk, not really that they'll sell off dollars, but as I said, the more moderate case, we won't get as much inflow as we need, or private investors--Scottish investment trusts and German pension funds and folks like that, will suddenly decide it's not a very good investment and will start dropping out or not buying more, and that's when the decline of the dollar could accelerate, push up our inflation and interest rates.

Keep in mind that the dollar fell substantially in 2002, 2003, and 2004. It fell by a trade weighted average about 15 percent with no noticeable adverse effect on the U.S. economy. Our inflation stayed low. Our interest rates didn't rise more than the Fed was doing with its measured tightening.

That was largely because our economy at that time had a lot of slack in it. We were coming off the recession of 2001. Now that we're much closer to full employment, a significant dollar decline, particularly if it was precipitous, would in fact push up inflation considerably more, and that in turn would pull up interest rates.

So now we are at greater risk, but if the dollar decline were gradual over a two or three year period again, I don't think the adverse effects would be so much. So even though there's lot of talk, speculation about hard landings and free falls of the dollar, I actually think that's not a huge risk.

The bigger one, and you mentioned that also, is what I call the domestic political unsustainability and the reaction through trade policy, and you raised Schumer-Graham, and yes, the fact that Schumer-Graham has been deferred for another six months, apparently in response to some nice dinners in the Great Hall, does reduce the pressure.

Now, I think there was a significant event last week, which was the introduction by Senators Grassley and Baucus of the Grassley-Baucus bill. I praised that strongly in my testimony of last Wednesday before the Finance Committee because I think it does two important things.

One, I think it would reform current law, which I know you had something to do with, the 1988 Act, but I think it reforms it in a constructive way to make the currency provisions much more operable. Instead of focusing on manipulation, the focus would be on fundamental misalignment, which I think is a much more meaningful concept and would, in fact, be much easier to demonstrate.

So the law would be more potent, but secondly and maybe more directly to your question, the Grassley-Baucus legislation introduces some important sanctions, which I think would be meaningful and very worrisome to China if they fell pray to them.

One is that if a currency was found to be in fundamental misalignment, the U.S. Executive Director at the IMF would be forbidden to vote for a quota increase in that country in the IMF, and incidentally, the U.S. has veto power. Any increase in national quotas, meaning voting rights at the IMF and World Bank, requires 85 percent vote, a supermajority. The U.S. has 17 percent and can veto.

So if this law passed and China were found to be in fundamental misalignment, which you'd have to find it on any analysis, the U.S. Executive Director, would have to veto any increase in IMF quotas for China.

Now, that may not sound like such big stuff, except that the Chinese want it badly, the Managing Director of the IMF is going to propose it, if not at the Spring Meetings in two weeks, at the Annual Meetings this fall, a series of selected quota increases, which I think are desirable to have China and Asian countries play a bigger role in the institutions, but obviously only if they're living up to the rules of the institutions, and that's the point here. If you're not living up to those rules, you shouldn't get a bigger share.

The second sanction in Grassley-Baucus would be to deny the administration the authority to reclassify China as a market economy, and that is a very big deal because the Chinese very badly want to be redesignated from non-market economy status to market economy status because of the way it would help protect them under the countervailing duty, antidumping statutes, et cetera, et cetera.

How do we know that? Every country that has sought a bilateral free trade agreement with China, New Zealand, Australia, a number of others, the Chinese have said we'll negotiate a free trade agreement with you, but first you have to declare us a market economy, prerequisite.

When President Hu took his ballyhooed trip around Latin America about a year ago, to offer big contracts, never fulfilled incidentally, but to offer big contracts on raw materials purchases, he insisted as a prerequisite that Brazil, Argentina, Chile, all the countries involved, declare China first a market economy. They want that very badly.

This law would bar the U.S. from giving them that change in terminology that is very important to them. And one could add other things. Now, one could take Mr. Hartquist's idea of bringing a case to the WTO once a currency was found to be in misalignment, one could add that to the list of Grassley-Baucus sanctions, could add another paragraph to their bill saying that if a country was found to be in fundamental misalignment, the U.S. government is instructed to take a case to the WTO to seek redress.

That's not in the current legislation, but one could add that. So you could have a series of remedies which are a little less extreme than the Schumer-Graham across-the-board import surcharge, but which would also be I think quite meaningful and could add to the arsenal of tools to promote international compliance with the IMF standards which are endorsed in Grassley-Baucus to avoid currency misalignments that undermine international economic balance, added to these imbalances and therefore contributed to the unsustainabilities that we're talking about.

HEARING COCHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Chairman Wessel and Commissioner Brookes, I want to congratulate you on this good day of hearings that you have put together. I want to thank this panel for your effort and your work in helping enlighten us.

I just want to add one more thing to the cyclingof the dollars that go to China. China invests them in our Treasuries, keeps our interest rates lower than they would be otherwise, and we get the goods.

Warren Buffett has one more thing he puts on it when the dollars go out there, they can also come back to buy assets in this country. I remember a couple of weeks ago when the Dubai port issue came up. Americans are wondering why everybody owns all these things in our country. Because I think Warren Buffett said we're the rich family living on the hill, no longer earning our way in life, so we're selling off part of our estate to finance a lifestyle we're no longer earning.

That's part of what is happening here. I had a chance to see Congressman Gephardt the other night. He was talking that China's like GMAC, they're loaning the money for us to buy their goods, and then we help by buying those goods, we help build their industrial base, so that's another take on this.

Dr. Bergsten, in your testimony, you say that the Treasury Department will lose all credibility if it fails in this coming report, due April 15, which I expect will be delayed until after the Hu visit, if they fail to name China a currency manipulator.

My recollection is last year, when Tim Adams, the Under Secretary of the Treasury, went to the IMF and said why aren't you being more aggressive about taking on China for the way it's behaving as a currency manipulator, the IMF went back to him and said you haven't named them a currency manipulator under your own law. So that was the take on this.

So the question I would have, it appears that in 1970, when President Nixon, I think it was August 15, 1970, took that action--

MR. HARTQUIST: 1971.

DR. BERGSTEN: 1971.

COMMISSIONER MULLOY: Okay. When he took that action, he relied on, I think it was Article 16 of the GATT that gives you the authority to impose import restrictions when you're in balance of payments difficulties. Is that another tool that we could have legally under the international system and still try and deal with this overwhelming unsustainability of our current account deficit? Has anybody thought about that issue?

Mr. Baugh.

MR. BAUGH: Actually we have, and we have raised it with USBIC that you can look at the provisions under the WTO about instituting an emergency import surcharge to bring your balance of payments closer together, and we're meeting with economists and others and engaged in a very serious discussion about that mechanism. Warren Buffett has suggested a corollary to that on how you could address that issue by having quotas and having a sale and a market approach to it.

Yes, there are a number of things that are under discussion as a possible way to do that. So the answer to your question is yes, we are talking with others, our counterparts in business, and the academic community about what begins to make sense here, and we've raised that as a possibility.

MR. HARTQUIST: If I can comment just briefly, Commissioner Mulloy.

COMMISSIONER MULLOY: Yes.

MR. HARTQUIST: I agree with what Bob has said and to me it was really shocking I guess it was last fall when the U.S. Under Secretary Tim Adams said publicly we, the United States government, would like the IMF to instruct us about what can be done to deal with this situation.

It was stunning that they would be asking the IMF, which has failed to move all along on this issue, tell us what we should do here, and so far I think the IMF has not responded. No reply.

COMMISSIONER MULLOY: When he testified at the hearing before Senators Grassley and Baucus last Wednesday at the Finance Committee, Dr. Bergsten was on the second panel, there were senators that were quizzing Mr. Adams, and he was giving that approach that we have to go to the IMF and get them to act before we can act.

There were many heads shaking, I thought in frustration, that we were handing over to this multilateral institution the authority that we have under our own law to call a spade a spade--that a country is one way intervention in the currency market, currency manipulator.

DR. BERGSTEN: Just to go back a step, if we wanted to invoke the WTO in response to a currency practice, the WTO rules call for it in turn to ask the IMF if the currency practice is as alleged. The WTO doesn't purport to have any expertise on the currency issue. That's the IMF's purview.

Previously GATT statutes like the one that the Nixon administration used in 1971 call for the WTO to formally request an IMF finding which, if positive then can be the basis for WTO action. WTO has to take a second step: is the action appropriate, legal, et cetera, et cetera, under GATT/WTO rules? So you do have to turn to the IMF.

Parenthetically, comments of Pascal Lamy were mentioned earlier. He made those remarks in a speech at my Institute about a month ago. I did not, I must say, take those dispositive. He was asked a question from the floor. I don't think he was all that prepared for it, and he's right in the sense that these provisions, the current provisions of WTO, have not been tested, the ones that Mr. Hartquist wants to use, but I think it has to be said it's an open book, and it could go either way.

But you would have to get the IMF, first of all, to find a balance of payments misequilibrium or, in the current case, a currency undervaluation.

I'd have to check this, but the provision that the Nixon administration used in 1971, which incidentally was challenged subsequently in the dispute settlement process, but the thing only lasted four months and it was eliminated before the case ever went very far. It was, incidentally, also challenged in our domestic courts as not being legal under U.S. domestic law, also never resolved.

Those older GATT rules were created in the original GATT after World War II in the context of a fixed exchange rate system.

COMMISSIONER MULLOY: Right.

DR. BERGSTEN: So there was lots of talk about balance of payments, surpluses and deficits, as opposed to currency misalignments, which is now the relevant variable, and so there has been some change in the rules and I'm not sure whether the '71 case would apply.

HEARING COCHAIR WESSEL: Commissioner Houston.

COMMISSIONER HOUSTON: Thank you all for being here. Dr. Bergsten, I'd like to thank you in particular for pointing out the Grassley-Baucus provisions because we get a lot of tighter, stricter vagaries in many hearings, and it's very nice to hear that there are some specific solutions out there.

My question is somewhat of a solution-based question. Part of the challenge is that it's very difficult to, especially in the United States, politically to trample on the economic sovereignty of another country, even if you completely and totally disagree with the monetary policy, whatever the particular principle is.

So there is an inherent basic challenge, and you had brought out, which was going to be part of my question anyway, that our unemployment right here in the U.S. is 4.7 percent. In the emergent and growth sectors and the tech sector, it's about 3.6, which I guess most economists would argue is almost zero. It's almost full employment.

I've read a lot of information about U.S. companies that have actually taken advantage of the problem with the Chinese dollar, and what they have done, or the Chinese currency, they have outsourced certain jobs, and that has given them the freed up capital here in the United States to actually grow some jobs.

Mr. Baugh, a lot of these companies that I've read about are in emergent and growth sectors, it's hard to argue that the people who have experienced job loss don't have an opportunity to move elsewhere.

I'd be interested to know as we're suffering under this problem with the Chinese currency, is there a movement in the manufacturing sector, in the private union sector, or is there even a will to take advantage of this, and to innovate and to change and to revamp the way of looking at things to see if there is a way to shift jobs and to take advantage of the fact that you can often outsource and find a way to grow jobs for your own workers at the same time?

MR. BAUGH: I guess I don't necessarily buy the scenario that that's what is occurring. We certainly have seen the job loss directly, and what scares us, what really concerns us, is about the future of the economy. It's not just the people on the production and assembly lines. We're seeing it in the engineers. We're seeing it in research and design. We're seeing it in the pieces of what you call the innovation economy, where the next best idea is supposed to come from, the next best idea, the next product, the next generation.

We see the technical capacity to make things being diminished, and that speaks to the future of the country and the job creation and job employment. That is it's a much broader picture and that, I think, should concern everyone if we are going to get out of this trade deficit.

You've got to be able to make things. If you don't make things, and we stop making things, we're not going to solve the deficit problem. It either means we're going to have to consume less or export more. I think we do want to export more, but the problem is we're diminishing the capacity to actually make things and export them, that's why I say people tend to look at us and say, oh, it's just you factory guys. It goes way beyond the factory.

This is the sector of the economy that accounts for two-thirds of the R&D. This is the sector of the economy that spends most on financial and technical services, and as that goes under, our ability to innovate. As I say, the technical capacity is undermined, and I think that is a real long-term threat to the nature of our economy in the future.

I would make the same connection that it goes actually to our defense base and our defense capacity. We've pursued globalization policies there as well, and what people don't seem to understand, when you lose 40,000. Let me put it this way. We have 40,000 manufacturing places closed of employment in the last five years beyond the three million jobs.

There are plenty of those places that one week they're producing for the consumer economy and the next they're producing for our defense base. You take those people out, not just the people who make the things, the skilled workers who are there, but the people who are also the engineers, the designers, and the people you count on to help keep us on the cutting edge of innovation, and they are out too. I think that has some pretty serious long-term implications for our economy.

COMMISSIONER HOUSTON: Okay. Two questions. Respectfully, that is a little bit at odds with some of the previous testimony we've had today, and in the past, which basically says that manufacturing or production in China is less primary innovation and more copycatting.

We had some testimony today about the quality of the engineering facilities and capability and education of the Chinese, and that it is much lower than ours. So I'm just curious, what that dynamic is. Then back to my original question, is the answer no, that there is no review or large companies looking at the possibility of how to shift some jobs to the advantage of others?

It's about the American worker and making sure that we're maintaining this more or less full employment that we have right now. So my question is over and above the currency problem, where is that going or has that stimulated any discussion at all in this area?

MR. BAUGH: Frankly, I’ve got to say it hasn't, in answering your second question first. The issue of the job shift is it's something to be concerned about, and we absolutely believe in retraining workers to work in other sectors of the economy. Frankly, this government does an absolutely inadequate job of that.

We do not have the social contract and protections that we actually see in some of our trading partners in terms of the ability to learn new skills and move on to other sections of the economy. In the long run, though, I think this assumption that we just let manufacturing go, that it's the wave of the past, and we've got this new economy, is very, very troubling for all the reasons I've just stated about the dynamics of our economy, the investment patterns in our economy.

That brings me to the point to your first question. Follow the money. Follow the pattern of direct investment that is going into China, and it's not just the production and it's not just the contracted investments there. But follow the R&D investments. Delphi Corporation, all the automobile industry is moving there, they're going to make parts. They're telling us they're going to bring ten billion back in the next couple of years.

You watch IBM just make a huge R&D commitment and investment in there. We're seeing this from the multinationals. Their perspective and point of view does not have much to do with reinvestment in our economy. It has to do with in fact capturing cheap labor and larger profits, and they're allowed to do this under our tax system and laws. They're encouraged to close factories in this country with the tax systems and laws we have in this place. It rewards this behavior.

There are a lot of problems in how the pattern of investments in China grew. But I would answer you to follow the money. These firms do not believe that Chinese workers are long-term or that Chinese engineering is long-term inferior to the United States. We made this same mistake in thinking about Japan 25, 30 years ago. The fact is they're smart people. They have an education system. They have a higher education system that's focused on some of these sciences, and they will certainly move upscale and they are not just producing.

I saw an article yesterday. I said, gee, China is finally beginning to move on beyond making toys and textiles. Well, guess what? They're getting far more sophisticated in the products they're making and that is really a mislabeling in how that economy is working and the knowledge that's going there. In fact, the strategic practices of this nation, and industrial policy and subsidies, and the very things you've looked at in the defense sectors and the ability and attempting to capture technologies, so in fact, they can move upstream, they are. They're going to go up the food chain. I have no doubts about it. Our firms are investing as we speak and making that happen.

HEARING COCHAIR WESSEL: Thank you. Commissioner D'Amato, and then two minutes each to Mr. Blumenthal and Mr. Mulloy.

COMMISSIONER D'AMATO: Thank you very much, Mr. Chairman, and thank you very much to the panel. This is a very interesting dialogue. I have to agree with what Mr. Baugh just said about following the money. I want to pursue that a little bit, but I can't help but comment on Mr. Bergsten's comment about the Chinese counting on the administration to protect it from Congress, a bet that to date has paid off. The odds are getting longer as we go along. Of course, the Unocal example is a good example, but aside from China, the reaction to the Dubai ports proposal also told you a little bit about the mentality up here.

It's like being in a western saloon, all the cowboys are in there and they've just run out of liquor, and after about an hour of this, a big dog runs across the saloon and everybody goes for their gun and blows the dog away. They don't know exactly why they did that, but Unocal comes in there and all of a sudden, boom. There is growing frustration here based on all of these issues, the persistence of them, not being solved.

But I want to pursue the follow the money because I think that there is an issue with regard to misalignment and correcting alignment that serves as an impediment to it, and it's our own companies and our own investment houses, that have invested more and more in China. In a sense they have become dependent on the misalignment for their own ability to export out of China. What--58 percent of our imports come from foreign-based multinationals, not Chinese companies, so the more and more that continues, it seems to me that there is a constituency in the United States that tends to impede realignment. The Chinese often complain that they are not getting that much out of this deal. In some respects, they're right.

So my question is to what extent the trade impacts that occur here, of course, come from a large and growing investment by companies, but also the investment houses are deeply involved in trying to acquire assets in China, and because the currency is misaligned, it's more lucrative for them to invest. Is that not the case? Do we see a more and more difficult set of restraints coming from our own corporate and financial structure for being able to bring about a realignment?

DR. BERGSTEN: You're certainly correct to note that the large majority of Chinese exports are generated by what they call foreign invested enterprises in China. 55 percent of total exports, 65 percent of exports to the United States. However, within that total, people sometimes overstate the importance of U.S. companies. The U.S. share of foreign direct investment in China is under ten percent.

COMMISSIONER D'AMATO: Oh.

DR. BERGSTEN: It's very modest. Most of the foreign investment in China comes from other parts of Asia, Hong Kong, Taiwan, increasingly Korea, booming, Japan. So the U.S. is a very modest share of it.

Now qualitatively I think your point is correct and you find very few large multinational American firms joining the attack on the Chinese currency practices. They don't say much one way or the other. But it's not because they're a dominant factor in the overall Chinese export picture. They're actually a rather modest share, again in the aggregate.

COMMISSIONER D'AMATO: That kind of clarifies it. I think there is a conventional wisdom that it's much larger.

DR. BERGSTEN: Yes, it's modest. It gives me a chance, if I may, Mr. Chairman, just to plug a book that I coauthored that we've just released in the last week leading up to Hu Jintao visit. It's a book we've done jointly with the Center for Strategic and International Studies which has done the security part of it, called The China Balance Sheet. It literally attempts, I think, for the first time to do a comprehensive factual and analytical foundation for understanding what the China challenge is and what it means to the U.S. and the rest of the world.

So I commend it you and hope you will absorb it. It is literally an effort to lay out analytical base for getting a handle on what the China challenge means. You all have been working on that for years yourself. This attempts to do it for a broad audience, but it's got a lot of analysis in there. In fact, like the point I just mentioned, there's a huge amount of actual material that might be helpful to you all in your deliberations.

COMMISSIONER D'AMATO: Thank you.

HEARING COCHAIR WESSEL: Thank you. Commissioner Blumenthal for two minutes.

COMMISSIONER BLUMENTHAL: Thank you. I guess with that book we can shut down the Commission. I'm looking forward to reading it. A quick question, and it presses Mr. Baugh's point a little. We did hear testimony earlier today that the Chinese economy is not innovating, that systemic problems within the Chinese economy cannot sustain.

I believe that all the numbers that we get about engineers actually not producing the kinds of things we produce here. It's my understanding that in terms of U.S. competitiveness, our economy now produces $5 trillion worth of IP a year, which is nowhere near what China can do.

Our R&D investment in both private and public just absolutely dwarfs Chinese R&D. So I think I'd like to take issue with the notion that we're not selling things, we're not exporting things,. Not being an economist, I'd actually like Dr. Bergsten to take issue with it if he wants to. If he disagrees of course, he can disagree.

But I think sometimes we can overstate these notions that somehow the Chinese are overtaking us in terms of all sectors of manufacturing and that there haven't been net gains to us in terms of the trading relationship. Dr. Bergsten.

DR. BERGSTEN: Yes. We have a section in the book called "Is China Becoming the New Technology Superstate?" And the answer is a ringing no, at least at this point, and for the foreseeable future. The quality of the engineers is a lot lower; maybe ten percent of them by most analysis might be internationally competitive.

The interesting point to note is that there's a huge amount of internal development in China for which these engineers are being trained. China now is building 60 to 70 major municipal subway systems. The United States is building none.

The Chinese are turning out tens of thousands of mechanical engineers, electrical engineers, civil engineers to build subway systems. Now you can say if they didn't do that, maybe they'd have to import the subway systems from Germany or somewhere, not from us, but that's not what we normally mean in terms of their developing a high tech skill base for international competition.

So a lot of it is that. We do go into that in detail in the book, and basically ratify the judgment you reported you had gotten earlier, not to say you shouldn't keep an eye on it, that China is attempting to move up the food chain as rapidly as they can, but they're still a long way from there.

People talk about the relative wages. Keep in mind that average productivity in China is five percent of ours, five percent. Now, when a Chinese worker moves from the rural sector to the marketized urban sector, he increases his productivity 16 times. So there can be big and rapid improvement, but the productivity of the country as a whole is still way, way behind ours.

Again, more goodies in the book.

MR. BAUGH: It makes part of my point, that in fact the migrant laborers do come to the cities, go to work in factories and the productivity goes way up.

DR. BERGSTEN: Oh, yes.

MR. BAUGH: So the competitive nature in the manufacturing economy is not the five percent we just heard for the overall China economy. I would just say do not underestimate both the knowledge and ability that is acquired from the technology that gets transferred and the ability to actually swim upstream and learn more about that, and learn how to implement and learn how to innovate, and I agree, no, they're not there yet, but I think we would be foolish to underestimate the ability and the will to do this.

If you just look at the last ten years, think about where they were in world export markets and where they are today and how fast money is going in and being invested in there, and it's not just the assembly business, it is the research and design.

That's where the money is moving now from all these companies. That's the part I say, if you think if it's not going to happen, pay attention to what's being invested and by our own firms.

HEARING COCHAIR WESSEL: Thank you. We're going to have a very quick question, Pat, please.

COMMISSIONER MULLOY: Yes, I would recommend that the commissioners might want to take a look at the hearing we did in April last year in Palo Alto on China's high tech economy, where we got into the venture capitalists and what's moving R&D-wise into China.

There's a good article in Business Week just pointing out that Intel is putting $1.3 billion into chip assembly in China, testing and research and development.

In the testimony we had earlier, the 11th Five Year Plan, these are their priorities--advanced computing, Internet programming, space satellite, space launched related capabilities.

These are not in a low-tech economy. Dr. Bergsten, Tim Geithner, who is now the head of the Federal Reserve Bank of New York, made a speech, I think it was on March 9, in which he said the Asians are managing the value of the dollar.

You make that point on your testimony, that you have to get China to move, but this is not just a China problem. This is Japan and others. Do you really feel we've got to get China to move before we get these other guys to move?

DR. BERGSTEN: Well, I think it's intimately related. I think one of the big reasons that the other Asians have been reluctant to let their currencies rise against the dollar is that the Chinese have kept their currency pegged to the dollar at this undervalued level. So if you're Japan or Korea or India, and you let your currency float up as it's supposed to do in the market and strengthen against the dollar, you're also strengthening against the Renminbi, and losing competitive position against your main competitor which is China.

So I strongly believe that if China can be persuaded or induced or whatever to let its exchange rate go up, say, 20 percent over a couple of years, the other Asian currencies will go up very largely with it. Our estimate is if all the Asian currencies go up 20 percent, U.S. current account deficit comes down by $60 to $80 per year.

So it's a big payoff in terms of our own external balance and therefore our own economy.

MR. BAUGH: I would just want you to understand, Commissioner Mulloy that this is absolutely been the analysis of the China Currency Coalition. In fact, the legislation that we have in Congress, H.R. 1498, the Hunter-Ryan bill, actually states it's about currency manipulation for all currencies, not just China.

It is directed towards these practices recognizing the fact that the China currency case is pivotal to what's going on with the rest of them, but we wrote legislation that addressed all of them.

HEARING COCHAIR WESSEL: Thank you. For a data question only and then we're going to close the panel.

COMMISSIONER D'AMATO: Maybe Mr. Bergsten is best on this. Given the fact that there is an interrelationship among the Asian currencies, as you point out, have you done a calculation as to what the multiplier effect would be in terms of positive impact on our overall trade balance if the Chinese were to appreciate their currency by "x" percentage and the rest of Asia would follow?

DR. BERGSTEN: Yes, it was roughly three to one. If you got a 20 percent revaluation of Renminbi and a lot of other assumptions, that would probably reduce the U.S. bilateral deficit with China by about $20 billion, about a billion dollars per percentage point. But as I said, if all the Asian currencies were realigned by a similar amount, we would get a reduction of $60 to $80 billion in our current account, so the multiplier would be three to four.

Another way to think of that is when you look at the trade weighted dollar index that the Federal Reserve maintains, which is essentially the trade shares of other countries in U.S. trade. China is about ten percent, East Asia or Asia as a whole is 40 percent. So it's got a four to one.

COMMISSIONER D'AMATO: Yes.

DR. BERGSTEN: So that's the rough relationship you should keep in mind, and why these multiplier effects are right, are important, and why the Currency Coalition is certainly right to address the whole range of Asian issues together. But I think quite logically they do because even when the Chinese let their currency move a little bit last summer, other Asian currencies responded quite sympathetically and you saw that relationship play out.

HEARING CO-CHAIR WESSEL: Thank you. As you can tell, there is substantial interest in the upcoming summit visit, state visit, whatever the qualifying nature of the visit is, so maybe we can have you back to discuss what happened.

[Whereupon, a short break was taken.]

PANEL VI: IMPACT ON CHINESE INDUSTRIAL SUBSIDIES ON U.S. INDUSTRIES

HEARING COCHAIR WESSEL: In our final panel today, we have Alan Price, who is a partner with the Wiley Rein and Fielding law firm. Mr. Price has more than 20 years of experience representing clients in high profile, complex international trade regulatory matters including trade litigation involving public and government relations issues.

In addition to being cochair of Wiley Rein & Fielding LLP International Trade practice, he heads the firm's antidumping and countervailing duty practice.

Our second panelist is John Magnus, President of TradeWins LLP. Mr. Magnus advises and represents clients on multilateral trade negotiations and WTO disputes. He also advises foreign governments on their trade regimes, and implementation of WTO rules, most recently in Beijing for the Asian Development Bank, and in the Caribbean region for the Organization of American States.

We will be less flexible with the rules with the time remaining for this panel, as it's late in the day. Seven minutes for oral testimony and then we'll open it up to questions.

Mr. Price, could you start.

STATEMENT ALAN H. PRICE, PARTNER, WILEY REIN & FIELDING LLP, ON BEHALF OF THE AMERICAN IRON AND STEEL INSTITUTE AND THE STEEL MANUFACTURERS ASSOCIATES

MR. PRICE: Good afternoon. I am Alan Price of Wiley Rein & Fielding. I'm appearing today on behalf of the American Iron and Steel Institute and the Steel Manufacturers Association. Together the members of these two associations account for the vast majority of steel produced in the United States.

China's compliance with the obligations it assumed upon its accession to the World Trade Organization has been seriously deficient. Nowhere is this more obvious than in the Chinese government's comprehensive support of its steel industry. Through a combination of direct subsidies including prohibited export subsidies, indirect subsidies such as the direction of credit, and the manipulation of its currency, the government of China has enabled the steel industry to expand to a size far beyond anything the market would have built.

The Chinese steel industry has expanded enormously over the past five years. Between 2000 and 2205, China's steel production grew from 126 million tons to 348 million tons of steel annually. The incredible growth was possible only because the Chinese government made a conscious decision to funnel tremendous resources into the steel industry.

The Chinese government holds a majority interest in every major steel producer and many minor ones. There are approximately 800 steel mills in China. Every province and every region in China seems to want its own steel mill and is willing to provide lavish benefits to build or keep its steel industry.

AISI and SMA are preparing a report that will examine in detail the subsidies that the Chinese government has provided and is providing to the steel industry. Today, I'd like to give just a few examples.

One, the transfer of facilities at below market prices. Because the government of China owns most steel companies, it can subsidize companies by transferring ownership or shares of facilities from one company to another, at below market rates or even at no cost.

Second, debt to equity swaps. This has been an extremely common way in which the Chinese government funds the steel industry. State-owned banks lend money at below market rates to steel producers. Then when the borrower is unable or unwilling to pay back even these subsidized loans, the banks convert the debt into equity in the company.

In 2000 alone, for example, the Chinese government converted more than $7 billion in direct financing into equity in 37 different Chinese steel companies.

Third, debt forgiveness and interaction regarding nonperforming loans. Closely related to debt for equity swaps is the frequent forgiveness of loans to steel producers by the Chinese government bodies.

Just as significant, though less obvious, is the failure of government bodies to force borrowers to actually pay their loans back.

Fourth, benefits for export performance. The Chinese government provides extensive benefits to steel producers that export a substantial portion of their production, primarily in the form of tax credits, but also through direct grants.

Fifth, control of raw material prices and exports. The Chinese government has imposed export restrictions or high export taxes on key steel-making raw materials such as coke and steel scrap, restrictions that have the effect of reducing domestic prices for these input below world market levels.

Of course, there is always currency manipulation. By keeping the value of the Chinese RMB artificially low, the Chinese government effectively subsidizes Chinese steel exports while making imports more expensive.

Some subsidies, such as tax benefits based upon export performance are clearly prohibited subsidies under the WTO subsidies agreement. Others such as the provision of subsidies to loss-making state-owned steel companies violate the obligations China assumed under its WTO accession agreement.

The net effect of these subsidies has been to drive the expansion of the Chinese steel industry to levels far beyond anything the market would have created. The Chinese government intends to continue this policy. In July 2005, China issued its new steel and iron industry development policy. The steel policy outlines a comprehensive plan for the continued expansion and modernization of the Chinese steel industry.

The policy prescribes the number and size of steel producers, where they will be located, the types of products that they will be allowed to produce and even minute details relating to the technology that will be used.

The steel policy mandates direct government subsidization of the steel industry in the form of tax refunds, discounted interest rates, funds for research and other benefits. The steel policy is a perfect example of the Chinese government's resolution to assert comprehensive control over the steel industry.

China's massive subsidization of the steel industry has global consequences. China has skewed the entire world market for steel and for steel raw materials. The expansion of China's steel industry has come at the expense of foreign producers. Not surprisingly, the rapid expansion of steel-making capacity in China has led, first, to the replacement of imports and then to a boom in exports. From wire rod, to seamless tubular products, to rebar, to flat roll products, Chinese exports have flooded world markets, driving down prices.

As steel production in China skyrocketed, so did demand for iron ore, scrap, coke and other inputs, largely as a consequence of the artificially high demand for steel in China, demand fueled by government policies and subsidies, the prices in the United States for steel scrap and other raw materials rose sharply and remain at near record levels.

China's insatiable demand for shipping for iron ore and for scrap imports and for steel exports has also caused a rise in shipping prices. All of these developments have harmed steel producers in the United States and other countries. Foreign steel consumers have also been injured by the subsidized expansion of the Chinese steel industry. American manufacturers of products that are steel intensive, such as auto parts and appliances are seeing increasing competition from Chinese producers who have access to domestically produced subsidized steel.

At the same time that U.S. steel producers are experiencing increased competition from Chinese imports, they are also watching many of their domestic customers move production to China to take advantage of these subsidies or go out of business altogether.

HEARING COCHAIR WESSEL: If you can sum up, please.

MR. PRICE: Thank you. The subsidized expansion of the Chinese steel industry has had one other truly global effect: pollution. China often does not adequately enforce its environmental laws. Many Chinese steel mills do not employ even the most basic pollution controls. It has been calculated that China is responsible for 25 percent of the worldwide emissions of particulates. The Chinese steel industry also discharges far more greenhouse gasses than the U.S. industry per ton of steel produced.

In conclusion, under true market conditions, China would undoubtedly have a large steel industry. It would not have a steel industry that accounts for 31 percent of total world production. The Chinese steel industry in its current form is the creation of the Chinese government. It has benefited from mass direct and indirect subsidies, many of which violate the WTO subsidies agreement, China's obligations under its WTO Accession Agreement, or both.

The growth of the Chinese steel industry has been at the expense of its international competitors. The Chinese industry's expansion has resulted in displacement of production in dozens of steel consuming industries from the United States and China at the cost of hundreds of thousands, if not millions, of American jobs.

The economic stability and security of the United States demand that the Chinese government end its policy of subsidization of the Chinese steel industry.

Thank you.

[The statement follows:]

Prepared Statement Alan H. Price, Partner, Wiley Rein & Fielding LLP, on behalf of the American Iron and Steel Institute and The Steel Manufacturers Associates

China's compliance with the obligations it assumed upon its accession to the World Trade Organization has been seriously deficient. Nowhere is this more obvious than if one examines the Chinese government's support of the steel industry in China. The American Iron and Steel Institute (AISI) and the Steel Manufacturers Association (SMA) have identified a number of ways in which the Chinese government has provided the Chinese steel industry with comprehensive support. Through a combination of direct subsidies, including prohibited export subsidies, indirect subsidies such as the direction of credit, and, above all, manipulation of the value of the Chinese RMB, the Chinese government has enabled and indeed required the Chinese steel industry to expand to a size far beyond anything the market would have built. These actions by the Chinese government are having profound consequences for both steel producers and downstream users of steel in other countries. The headlong expansion of the Chinese steel industry is also having a negative impact on the global environment.

The Chinese Steel Industry Has Expanded Enormously in Five Years

To understand the full scale of China's subsidization of its steel industry, it is necessary only to review a few statistics. In 2000, China produced 126 million tons of steel, about 20 million tons more than the next largest producer, Japan. In 2005, China made 348 million tons of steel, an increase of 175 percent in only five years. This was more steel than the next three largest producers combined. Over this period, China moved from a net importer to a net exporter of steel.

How was such a dramatic and indeed unprecedented expansion of capacity possible? The short answer is that the Chinese government made a conscious decision to funnel tremendous resources into the steel industry. It did so in violation of both its WTO commitments and the logic of the market.

The Chinese steel industry continues to be primarily state-owned. Although minority positions in some of the larger producers are privately owned, the Chinese government holds a majority interest in *every* major Chinese steel producer. The structure of the Chinese steel industry reflects the pervasive influence of the Chinese government. The Chinese industry is extremely fragmented. There are approximately 800 steel mills in China. This fragmentation reflects the active intervention of the Chinese government at all levels – national, provincial, and local – in the steel industry. Every province and every region seemingly wants its own steel mill, and is willing to provide lavish benefits to build or keep its steel industry.

The Chinese Government Provides a Range of Subsidies to the Steel Industry

The ways in which the Chinese government has subsidized the steel industry are manifold and ingenious. AISI and SMA are preparing a report that examines these subsidies in great detail. The following are just a few examples of the various direct subsidies the Chinese government has provided the steel industry.

Transfers of ownership. Because the Chinese government owns most steel companies, it can subsidize companies by transferring ownership of shares or facilities from one company to another at below-market or even at no cost. For example, in January 2005, the Government of Hubei Province transferred a 51 percent stake in Ercheng Iron & Steel, a local steel producer with a production capacity of 3 million tons per year, to another state-owned producer, Wuhan Iron and Steel, at no cost – even though Ercheng had been profitable.

Cash grants. The Chinese government has admitted that it continues to provide direct grants to steel producers that incur losses, even though it had promised in its WTO accession agreement not to do so.

Debt-for-equity swaps. This is an extremely common way in which the Chinese government funds the steel industry. State-owned banks lend money at below-market rates to steel producers; then, when the borrower is unable to pay back even these subsidized loans, the bank converts the debt into equity in the company. In 2000 alone, the Chinese government converted more than $7 billion in direct government financing into equity in 37 different Chinese steel companies. The *Asia Times Online* reports that, in the years leading up to 2005, China's iron and steel companies benefited from debt-to-equity swaps worth 11.19 billion yuan as part of the government's plan to restructure and consolidate the steel industry.

Debt forgiveness and inaction regarding non-performing loans. Closely related to debt-for-equity swaps is the frequent forgiveness of loans to steel producers by Chinese government bodies. One of the most prominent was the write-off by the Heilongjiang provincial government of $4.4 billion worth of non-performing loans owed by state-owned industrial enterprises, including local steel producers. Just as significant, though less obvious, is the failure of government bodies to force borrowers to pay non-performing loans. As much as $800 billion worth of state-owned banks' loans are non-performing.

Benefits for export performance. The Chinese government provides extensive benefits to steel producers that export a substantial portion of their production, primarily in the form of tax credits, but also through direct grants. On their face, these benefits would appear to be subsidies contingent on export performance, which are explicitly prohibited by the WTO agreement on Subsidies.

Energy and raw material grants. The Chinese government has provided grants to fund the purchase of energy and raw materials, either in the form of money or in kind, to steel producers, including the provision of coking coal and iron ore to Shougang Steel by the Shanxi provincial government in exchange for Shougang's assistance in the ongoing restructuring and upgrading of the steel industry.

Preferential loans and directed credit. The Chinese government owns all of the major banks in China - the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China. These four banks alone account for over 60 percent of all loans. The government frequently directs the banks to make loans to individual steel companies on non-commercial terms.

Control over raw material prices and exports. The Chinese government has imposed export restrictions or high export taxes on key steelmaking raw materials such as coke and steel scrap, restrictions that have the effect of reducing domestic prices for these inputs below world market levels. The Chinese government has also threatened to use import licensing schemes to control the price of imported iron ore.

Import barriers. High tariff rates and other barriers protect the Chinese steel industry from competition from imports.

Barriers to foreign investment. Chinese law prohibits foreign companies from owning majority stakes in Chinese steel companies and requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. While this might appear likely to prevent the expansion of capacity, its major effect is to prevent that rationalization of capacity through the purchase and consolidation of Chinese steel companies by foreign investors.

Currency manipulation. By keeping the value of the Chinese RMB artificially low, the Chinese government effectively subsidized Chinese steel exports, while making imports more expensive.

Some of these subsidies, such as tax benefits based on export performance, are clearly prohibited subsidies under the WTO Subsidies Agreement. Others, such as the provision of subsidies to loss-making state owned steel companies, violate the obligations China assumed under its WTO accession agreement. The net effect of these subsidies has been to drive the expansion of the Chinese steel industry to levels far beyond anything the market would have created.

The New Steel Policy Is a Prescription for More Subsidies

Nor can there be any doubt that the Chinese government fully intends to continue on this course of extensive control over the steel industry. In July 2005, the National Development and Reform Commission ("NDRC") issued China's new Steel and Iron Industry Development Policy ("Steel Policy"). The Steel Policy outlines a comprehensive policy for the continued expansion and modernization of the Chinese steel industry. The policy prescribes continued government involvement in all aspects of the management of China's steel industry, including resource and equipment utilization, regional concentration of output, quality improvements, technological innovation, investment management, and consolidation. Article 20, for example, provides for the strategic reorganization of China's largest steel producers to create an industrial structure with two 30 million-ton steel groups and several 10 million-ton level steel groups by 2010. The policy further prescribes the number and size of steel producers, where they will be located, the types of products that are allowed to be produced, and even minute details relating to the technology that will be used (e.g., size and composition of blast furnaces).

The Steel Policy mandates direct government subsidization of the steel industry. For example, Article 16 specifically provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel project utilizing newly developed domestic equipment." The policy also calls for indirect support, by among other things, restricting foreign investment, discriminating against foreign equipment and technology, and by providing various export credits. In short, the Steel Policy is a perfect example of the Chinese government's resolution to assert comprehensive control over the steel industry, arrogating to itself decisions that the entire WTO framework assumes should be made by the market.

China’s Subsidization of the Steel Industry Is Having Negative Global Consequences

China’s massive subsidization of its steel industry is having consequences that are truly global. By expanding its steel industry by government fiat, rather than in response to the demands of the market, China has skewed the entire world market in steel and in the inputs used to make steel. In doing so, it has directly injured both foreign steel producers and steel consuming industries in other countries.

The expansion of China’s steel industry has come at the expense of foreign producers. China’s explosive growth between 2000 and the present required massive amounts of steel, and indeed, during much of this period China was the world’s leading steel importer. By building up its steel industry to artificial levels, though, China deprived steel producers in other countries of valuable sales. This is significant, because steel is a highly cyclical industry; producers depend upon high production and prices in good times to help them weather the inevitable downturn.

Not surprisingly, the rapid expansion of steelmaking capacity in China led first to the replacement of imports, and then to a boom in exports. In product line after product line, from wire rod and seamless tubular products to rebar, and flat rolled products, Chinese exports have flooded world markets, driving down prices.

The Chinese steel producers have initially targeted their neighbors. Large quantities of Chinese steel are forcing their way into the Australian, Japanese and Korean markets, among others. This in turn encourages the producers in those countries to seek other markets for their production – and the United States is the largest and most open of these markets. The United States has experienced massive increases in imports from these countries.

The world in many ways constitutes an integrated market for steel. Through a dramatic expansion in capacity fueled largely by subsidies and government-directed lending, the Chinese steel industry is destabilizing that market. It is only a matter of time before the effects of the Chinese expansion become obvious in the U.S. market, to the detriment of U.S. steel producers and U.S. steel consumers.

The dramatic expansion of the Chinese steel industry has had another, equally direct impact on steel producers elsewhere. The Chinese government has driven demand for steel in China to artificially high levels through various policies and subsidies to other steel consuming industries. As production in China skyrocketed to respond to this artificial demand, the Chinese steel industry’s demand for iron ore, scrap, coke, and other inputs into steelmaking also skyrocketed. Among other consequences, this was a major cause of the precipitous increase in prices for steel scrap in the United States, which remain at near-record levels. China is the world’s largest coke producer; export restrictions on coke in 2004 had a similar impact, driving prices outside of China to levels twice as high as prices inside China. China’s insatiable demand for shipping for iron ore, scrap, and steel exports also caused a rise in shipping prices. All of these events harmed steel producers in the United States and other countries.

Foreign steel producers are not the only ones harmed by the subsidized expansion of the Chinese steel industry. Foreign steel consumers have also been injured. The expansion of the steel industry is only part of the Chinese government's plan for the development of the Chinese economy; the Chinese government is also encouraging the development of manufacturing industries that use steel. Manufacturers of products that are steel-intensive, such as automotive parts and appliances, are seeing increasing competition from Chinese producers who have access to subsidized domestic steel. Subsidized steel is going to manufacture components in China that ultimately end up in the United States and replace American steel. Indeed, American consumers report that they can import finished parts cheaper from China than they can buy the steel here. At the same time that U.S. steel producers are seeing increased imports caused, directly and indirectly, by increased Chinese production, we are also seeing many of our domestic customers move production to China, or go out of business altogether.

The Chinese Steel Industry Is a Major Polluter

The subsidized maintenance of many small, old and inefficient steel facilities in China have had another, truly global effect – pollution. Although China has relatively strict environmental laws on the books, it often does not adequately enforce them. All too often, many older Chinese plants, including in the steel industry, do not employ even the most basic pollution control measures. It has been calculated that China is responsible for 25 percent of worldwide emissions of particulates, and that the Chinese steel industry discharges far more greenhouse gases than the U.S. industry per ton of steel produced.

Concluding Thoughts

China is a major economic power. Under true market conditions, China would undoubtedly have a large and diverse steel industry. It would not have a steel industry that has grown to account for a staggering 31 percent of total world steel production. The Chinese steel industry in its current form is the creation of the Chinese government. It has benefited from massive direct and indirect subsidies, many of which violate the WTO's Subsidies Agreement, China's obligations under its WTO accession agreement, or both. The Chinese government has adopted an official policy that requires it to continue to provide the steel industry with massive subsidies.

The consequences of these actions have been profound. The growth of the Chinese steel industry has been at the expense of its international competitors. The Chinese steel industry's expansion is simply one component of an overall strategy that has resulted in the displacement of production in dozens of industries from the United States to China, at the cost of hundreds of thousands, if not millions, of American jobs. Because the Chinese steel industry is a major emitter of pollutants and greenhouse gases, the long-term impacts may be even more severe. The economic stability and security of the United States demand that the Chinese government end its policy of subsidization of the Chinese steel industry.

HEARING COCHAIR WESSEL: Thank you. We look forward to the dialogue afterwards. Mr. Magnus.

STATEMENT OF JOHN R. MAGNUS
PRESIDENT, TRADEWINS LLC

MR. MAGNUS: Thank you very much and good afternoon. It's an honor to be here and I want to congratulate the Commission for holding a hearing on this topic, Chinese subsidies. It's an important one.

I will have a statement in electronic format to submit this afternoon. It's nice going last because there are a number of things that have been said and don't need to be reiterated. I would like to just take two minutes on the countervailing duty issue, two minutes on the currency issue, maybe one minute on the CFIUS issue, and one minute on the subsidies element of the WTO negotiations, which I think is an important bit of the backdrop that you all should be keeping in mind.

On the countervailing duty law, first, my view is that the countervailing duty law should apply to imports of any origin, including non-market economies. It's an important interface mechanism. It's not controversial policy-wise. It improves the situation of domestic industries that are facing subsidized imports and, not least, it actually discourages wasteful subsidies. So it's a pretty good package deal.

There is no WTO obstacle to extending the law in that fashion. As you think about the countervailing law and its applicability to Chinese products, just three things to keep in mind. One is that legislation may not be necessary.

The case law, the legal impediment to conducting countervailing duty cases now on non-market economy products is this court decision you've probably heard about from 1986, Georgetown Steel. It's an old decision. It interpreted a law that was repealed in 1994, and the countervailing duty law on the books today has a definition of a subsidy in it that pretty clearly applies to things that the government of China can do.

In fact, my understanding is that the new auto parts case includes a subsidy claim. If the government of China were incapable of carrying out actions that meet the definition of a subsidy, then it would certainly not be appropriate to include a subsidies claim in this new case or to have negotiated with China during the accession process, line by line, about how the subsidies agreement was going to apply.

So the idea that somehow there is some legal impediment to this, I don't really get it, and I don't understand fully why we haven't seen a test case. But that is an alternate path that could lead to the extension of the countervailing duty remedy to cover non-market economy products.

That said, unfortunately, I think the Commerce Department in its practice is heading in exactly the wrong direction. You should know that the last time they had a chance to look at this issue or a closely related issue, they actually expanded the exemption for non-market economy products rather than narrowing it.

This was in a case about two years ago, three years ago, where they were looking at the question of pre-graduation subsidies. You understand for antidumping purposes, when a country is considered to be a non-market economy, it goes through a transition. At the end of that transition, it graduates to market economy status.

This happened recently for Russia, for a number of other former Soviet bloc states, et cetera.

The first time that the Commerce Department processed a countervailing duty case on a graduated country--this was Hungary--one of the subsidy allegations was about a great big cash subsidy that came in just before the graduation date. Hungary graduated on the first of January of 1998, and these large subsidies had come over the transom in the second half of 1997, and the countervailing duty case came along about 1999 or 2000.

Commerce Department said, "Well, we can't look at that. That was before they graduated." This was a large subsidy that ordinarily would have yielded a benefit for ten or 15 years, a substantial benefit for ten or 15 years, and driven up the countervailing duty rates, but the Commerce Department took a theological approach and said, "well, a subsidy that was bestowed before graduation wasn't a subsidy at all; it was something else." There is no legal basis for that decision, and it's bad policy. It could be revisited, should be revisited.

A final point about the countervailing duty extension is that the methodological issues that have been debated about, I think have been very significantly overblown. They're not that worrisome, particularly the issue of double counting subsidies. The double counting concern--in other words, the concern that the special non-market economy methodology that the Commerce Department applies on the antidumping side is going to somehow pick up and offset the benefit of any government subsidies so that it would be double counting or double relief you also offset them through a countervailing duty case--the risk of that exists only where you have parallel countervailing and anti-dumping cases and only for certain kinds of domestic subsidies, not including significant ones such as debt relief. Debt relief is probably the most numerically significant kind of domestic subsidy the Commerce Department ever sees. And there is no argument that there would be double counting to pick that up in a countervailing case or that that somehow has already been offset through the antidumping process.

So I think that concern about double counting has been significantly overblown. No reason that I can see why legislation, if legislation is going to be the way by which the countervailing law gets extended, no reason why legislation needs to tackle that at all.

I think the same is true about the benchmarks, but I won't go into the details because we're short of time.

On currency, you've heard a lot about that in the last panel. I will for what it may be worth give you my own scorecard. Bearing in mind, of course, that extending the countervailing duty law to China does not tell you one way or the other whether the currency regime confers something that is cognizable or reachable as a subsidy under the definition of the subsidies agreement.

From where I sit, the financial contribution requirement is clearly satisfied. It's satisfied each time there's an exchange transaction. When an exporter who has been paid in dollars takes those dollars back to the central bank, trades them for yuan, that's enough right there. And, yes, it's true that means that every government that is engaging in exchange transactions is providing a financial contribution. But that's not really such a big deal.

The question is, is there a benefit? And that's where the claim with respect to China's currency regime is on a much steeper upward slope.

To claim that the financial contributions confer benefit is based on, of course, an implied comparison to the probable free market value of the yuan, which many economists think is undervalued. Certainly if market fundamentals are dictating that the exchange rate should be somewhere around five and it's being pinned above eight, well, then in the lay sense of the term, that would certainly sound like a benefit. It would result in a much greater export turnover, export volume, and revenues. But, of course, benefit in the subsidies agreement context is a technical term with a technical meaning, and you have to evaluate the benefit in a way that corresponds to how you define the financial contribution.

If I have defined it correctly, which is basically the exchange of one currency for another, then the question is whether the government is providing more than adequate remuneration or receiving less than adequate remuneration, and all the normal tests that you would use to check for that are unavailable here because there is no separate private market where the exchanges are occurring at some rate other than the one that's been set by the government of China.

I'll save the rest of that for questions except to note that if there is also a currency hedging service that's being bestowed here, that's also a separate financial contribution, relieving China's exporters of the necessity of actually paying for currency hedging instruments. That would be maybe an easier benefit analysis because as near as I can tell, there is no charge being made for that at all, and no charge sounds to me like less than adequate remuneration.

HEARING COCHAIR WESSEL: If you can sum up?

MR. MAGNUS: Yes. Quick point on investment review. My own tendency is to be a little bit skeptical of the idea of trying to take subsidies or subsidy allegations into account in the investment review process, and the reason is that unlike in the case of trading goods when you have subsidized goods coming into the United States, there are winners and losers domestically. There are consumers who get to buy cheaper products, but there are domestic industries who have to compete at that lower price point.

In the case of an investment that is said to be subsidized, it looks to me like it's all gravy. In other words, it's going to drive up the price received by whoever the U.S. owner is of the asset, and I don't see who suffers from it. Unless it's possible to identify somebody who suffers from it, then it's hard for me to see why that factors appropriately into the national security calculus that gets done in a review of an incoming investment.

Last point, on the WTO subsidy rules, which I would encourage you just to keep an eye on because the trend of the negotiation on subsidies, in the rules negotiating group of the Doha Development Agenda, is toward diluting, dramatically weakening the existing disciplines on subsidies. This will have a bearing, if it happens, on our ability to respond to subsidies bestowed by China and other governments over time and that part of the negotiation is not at all on a track that looks encouraging.

Thank you very much.

[The statement follows:]

Prepared statement of John R. Magnus
President, TRADEWINS LLC

CHINESE SUBSIDIES AND U.S. RESPONSES

Good afternoon and congratulations to the Commission for devoting attention to the important issue of Chinese subsidies. It is a great honor for me to be here.

My perspective is that of a subsidy hawk. I have spent the better part of my professional life working to utilize, and to improve, existing subsidy disciplines and remedial tools. The views expressed here reflect that experience and are personal ones, not attributable to any client or any other organization with which I am affiliated.

The Commission's staff has circulated questions in three broad categories, on the *impact* of China's subsidies, on their *WTO-consistency*, and on *recommendations* ("What actions could the U.S. government take to create stable and fair U.S.-China trade?"). I can best assist the Commission by focusing on the third topic. Other witnesses have important things to say on the effects of Chinese subsidies in various sectors and geographic markets, especially the U.S. market; and China's failure to provide WTO-mandated subsidy notifications, and to rescind particular agricultural and industrial subsidies in a timely fashion, has been documented in the annual transition/review process and elsewhere. For example, the U.S. forest products industry has documented extensive direct subsidies in China, including debt forgiveness, soft loans and tax incentives, as well as indirect aid (loan and equity subsidies) provided at the behest of the central government or a local government.

As for recommendations, how to foster "stable and fair U.S.-China trade" is a broad (and very tempting) question, but I will confine my comments here to actions responsive to the problem of Chinese subsidies. Among the many options worth considering and currently subject to debate, I will focus on three: (I) use of countervailing duty ("CVD") law with respect to subsidized imports from China; (II) use of WTO dispute settlement (or CVD law) to address China's currency regime as a prohibited or actionable subsidy; and (III) taking subsidies, and subsidy allegations, into account in Exon-Florio reviews of inbound investments.

To begin with the punch line: the first is something the U.S. government *should* do; the second is something it *might be able* to do; and the third is something it *should not* do.

I. Extending the CVD Law

I believe a CVD remedy should be available with respect to goods of any origin, including those from countries designated as non-market economies ("NMEs"), such as China.

The CVD remedy is an important interface mechanism between economies, is relatively non-controversial policy-wise, and -- in addition to improving the lot of domestic industries harmed by subsidized import competition – has the virtue of actually discouraging wasteful subsidization. There is no WTO obstacle to applying the CVD remedy to NME products, and indeed importing jurisdictions other than the United States either have done so or would do so in an appropriate case.

As the Commission ponders what it might wish to say or do regarding this policy option, there are three points I would suggest keeping in mind: (1) legislation may not be needed; (2) Commerce in its CVD practice has been needlessly making the problem more rather than less difficult; and (3) the methodological concerns, especially regarding benchmark selection and possible "double-counting," are not as serious as some of the recent public debate would lead one to believe.

First, it is not clear that legislation is needed. The presumed legal impediment to CVD cases targeting NME products today is a 1986 court decision, *Georgetown Steel v. United States*, 801 F.2d 1308 (Fed. Cir. 1986). But there is some question whether *Georgetown Steel* is still good law – whether, in view of statutory changes, a CVD case could be filed against NME exports today. The CVD law interpreted in *Georgetown Steel* was after all repealed in 1994 through the Uruguay Round Agreements Act, and the surviving CVD law was substantially amended -- notably through the inclusion, for the first time, of a definition of the term "subsidy." This definition copies almost verbatim Article 1 of the WTO *Agreement on Subsidies and Countervailing Measures* ("ASCM"), and its basic elements are a financial contribution and conferral of a benefit. *See* 19 U.S.C. §1677(5). This definition is not confined to activities engaged in by governments holding power in market-oriented economies; on the contrary, WTO Members have made clear that a NME government can bestow a "subsidy" according to the ASCM definition. Evidence for this includes, for example, the detailed negotiation with China about its right, after accession, to benefit from the various special "developing country" rules in ASCM Article 27 – a negotiation that would have been unnecessary had China been considered incapable of carrying out the actions described in ASCM Article 1. Press reports regarding the new U.S. and EU requests for consultations with China regarding auto parts indicate that the complaints include a claim of subsidies contingent on the use of domestic over imported products. Such a claim would make no sense if China were incapable of carrying out actions that meet the basic ASCM Article 1 definition of a subsidy.

1994 amendments aside, the actual holding of *Georgetown Steel* was that Commerce was not *obligated* to accept CVD petitions targeting NME products. There is no court holding on whether Commerce is *permitted* to accept such petitions. At issue in *Georgetown Steel* was whether Commerce had acted lawfully in terminating, and refusing to conduct, CVD investigations on products imported from several Soviet-bloc countries. Commerce had reasoned that the CVD law invoked could not be applied because concepts like subsidization and resource misallocation were meaningless in the context of a centrally planned economy. The question on appeal was whether Commerce's interpretation was permissible. The Federal Circuit said yes, finding Commerce's determination to be neither contrary to law nor an abuse of discretion. The Federal Circuit also added some *dicta* indicating its view that Commerce *could not* have applied the CVD law to NME products – but it was addressing, here, a hypothetical question.

And even these *dicta* rested on the practical difficulties impeding CVD analysis in a NME environment. The Federal Circuit reasoned that Congress *must* have intended to exclude NMEs because of the difficulty of determining the amount of the unfair advantage bestowed by a foreign government on an investigated firm. *Georgetown Steel*, 801 F.2d at 1315-16. The key issue, for the Federal Circuit and for Commerce, was the inability to identify benchmarks in the distorted NME environment. *See id.*, 801 F.2d at 1317-18; *Czech Wire Rod*, 49 Fed. Reg. at 19,376 ("Subsidies in market economy systems are exceptional events. They can be discerned from the background provided by the market system. No such background exists in an NME…. In such a situation, we could not disaggregate government actions in such a way as to identify the exceptional action that is a subsidy."). The benchmarks regularly needed in CVD analysis include, for example, market-determined prices against which Commerce can compare the price charged for a government-provided input, and market-determined interest rates which Commerce can use to capture the "time value of money" element of large non-recurring subsidies. In a thoroughly distorted NME environment -- before the transition to market economy status has begun, or even early in that transition -- these market-determined comparison points may indeed be difficult to pinpoint. While some subsidies (*e.g.*, a per-unit export bounty) could be readily identified and measured, an overall assessment of a given enterprise's level of subsidization in such an environment would be speculative. *Georgetown Steel* can be read as holding that such practical difficulties can be so substantial as to override what is otherwise a clear statutory mandate to countervail bounties and grants. But in an economy that has for many years been in transition – *i.e.*, in the NMEs of today -- valid benchmarks may well be available. To ignore this and hide behind *Georgetown Steel* as a permanent shield against NME countervail cases is revisionism, an attempt to recast in theological terms what was essentially a pragmatic (and legally superfluous) discussion by the 1986 court.

In any event, an interesting question of first impression would be presented if a U.S. industry filed a CVD petition against NME imports today, under today's CVD law. Commerce might accept the petition. And if Commerce decided it could not, the reviewing courts might disagree. I wonder, and I know others do as well, why we have not seen a test case.

Second, Commerce's practice has been moving away from, not toward, this result. Unfortunately, far from narrowing or reconsidering the "NME exemption," the agency has been expanding it. In particular, *Sulfanilic Acid from Hungary*, 67 Fed. Reg. 60,223 (final) (2002), carved a significant *additional* hole in the CVD law's protection by ruling that large non-recurring subsidies bestowed in a foreign country prior to its "graduation" from NME status are not countervailable even after graduation. I have previously published a critique of this decision, in the Summer 2004 issue of *Harvard International Review*, and have made a copy of that article available to the Commission's staff. Accordingly, I will only briefly recite the highlights here.

The subsidies in question, a cash grant and an assumption of environmental liabilities, were bestowed during the last six months before Hungary's January 1, 1998 "graduation date." Ordinarily, such subsidies are amortized over the average useful life of renewable assets in the industry involved, in this case 11 years. So, if these 1997 bestowals were treated as subsidies, they would have yielded an allocated benefit in the "period of investigation" for the CVD case (calendar 2000). But Commerce determined that it was under no obligation to include pre-graduation subsidies in its calculations and, in fact, was precluded from doing so. Commerce relied on *Georgetown Steel*, maintaining that the issue had already been resolved there.

Problems with this decision include: (1) *Georgetown Steel* did not reach, or dictate the answer to, the question presented in *Sulfanilic Acid*. The court did not lay out rules for what would happen if a NME country graduated to market economy status, and a later CVD case included subsidy allegations dating from the pre-graduation period. (2) The *Sulfanilic Acid* rule contradicts Commerce's practice in graduating countries from NME status – a practice which recognizes that the transition process is gradual and not abrupt. (3) Commerce's *per se* rule on pre-graduation subsidies is bad policy as it encourages the bestowal of large capital subsidies in transitional economies. Under it, large subsidies which are bestowed just prior to a country's graduation, and which should be subject to CVD offset for the next 10-15 years, can continue to have trade-distorting effects and yet face no offset at all.

Since amortizable subsidies typically account for a sizable portion of the CVD rates calculated for industrial products -- *Softwood Lumber*, based mainly on recurring subsidies, being the notable exception -- the question of "how far back" one can look for subsidies is likely to be critical in any future CVD cases involving NME products. Unlike the methodological issues mentioned below, I believe this issue should be addressed in any CVD extension legislation.

Third, the methodological concerns about "how" to extend the CVD law to reach NME products have been overblown. This is particularly true with respect to possible double-counting – that is, the concern that the special *antidumping* calculations Commerce uses in an NME case may already include a full offset for government subsidies, so that offsetting those subsidies separately through a CVD order would provide double relief. This risk is present only when parallel AD and CVD cases are pursued, and then only for certain kinds of domestic subsidies. (Export subsidy margins are automatically deducted from antidumping margins, regardless of whether the exporting country is an NME.) Even advocates concerned about double-counting acknowledge that debt relief, for example, is not picked up or offset through the NME antidumping methodology. And debt relief is one of the most numerically significant categories of domestic subsidies Commerce encounters in CVD cases. Commerce has ample authority and expertise to avoid double counting in those circumstances where the risk is present. I see no reason why legislation extending the CVD law to cover NME products needs to mention this issue.

On benchmarks, too, I see no need for new statutory language because Commerce already has the authority and expertise to handle this issue appropriately. One noteworthy "CVD extension" bill contains China-specific language authorizing Commerce to "use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in China may not always be available as appropriate benchmarks," and further advising Commerce to seek to "adjust" terms and conditions observed to be prevailing in China before "considering the use of terms and conditions prevailing outside China." H.R. 3283, section 3(a)(2). There is nothing particularly wrong with the approach envisioned here, but it seems to match what Commerce would already do under the existing statutory provisions on measuring subsidies. CVD extension legislation could safely skip over this topic.

II. Challenging China's Currency Regime as a Subsidy

Applying the CVD law to Chinese products does not, of course, resolve the separate question whether China's currency regime can successfully be challenged as a subsidy. Some recent commentaries and position papers have wrongly conflated these two issues. Whether the currency regime can be characterized as a subsidy -- in CVD cases or in a WTO dispute settlement case – depends on whether the required elements as set out in the ASCM are present.

The China Currency Coalition ("CCC") has briefed this issue in detail, both in section 301 petitions seeking resort to WTO dispute settlement and, most recently, in Skip Hartquist's testimony today. Some of the issues are clear, some less so. My scorecard, for what it may be worth, is as follows:

China is subject to the prohibition on export-contingent subsidies. Export-contingent subsidies are so strongly disfavored that WTO rules, beyond the basic "prohibition," require expedited action by an offending Member and (absent such action) provide for retaliation that is not limited to trade effects. During its WTO accession talks, China committed to "eliminate all export subsidies, within the meaning of Article 3.1(a) of the SCM Agreement, by the time of accession. To this end China would, by accession, cease to maintain all pre-existing export subsidy programmes and, upon accession, make no further payments or disbursements, nor forgo revenue, or confer any other benefit, under such programmes." Working Party Report, WT/ACC/CHN/49, at 33; *see also* Accession of The People's Republic of China, Decision of 10 November 2001, WT/L/432.

The "financial contribution" requirement is satisfied. When a Chinese exporter, having been paid in dollars, comes to the Central Bank to trade those dollars for *yuan*, that exchange would seem to qualify as a financial contribution under ASCM Article 1.1(a)(1)(iii) ("a government provides goods or services …, or purchases goods"). It should make no difference, at this stage of analysis, whether the exchange is characterized as the government selling *yuan* or buying dollars. To the extent that there is any question whether money can be characterized as a "good" for purposes of Article 1.1(a)(1)(iii), the exchange transaction would also seem to qualify as a "direct transfer of funds" under Article 1.1(a)(1)(i). The CCC has asserted that the government in this context is also providing a service – basically a currency hedging service – which would qualify as a financial contribution under Article 1.1(a)(1)(iii) as well.

Under this reading, all governments that participate in exchange transactions are providing financial contributions – either directly under Article 1.1(a)(1)(iii) or, if they rely on private banks to handle exchanges, via the "entrusts or directs" standard of Article 1.1(a)(1)(iv). To hold otherwise would require doing violence to the plain language of Article 1.1(a). The interesting question is whether these financial contributions confer a benefit.

Showing a "benefit" is challenging. The claim that the Chinese government financial contributions at issue here confer a benefit rests on a comparison to the "probable free-market value of the *yuan*," which some (but not all) economists regard as significantly undervalued – meaning that the government is giving out "too many *yuan*" in post-export exchange transactions.

Holding the exchange rate above 8 *yuan* to the U.S. dollar, if market fundamentals suggest something closer to 5, would certainly convey a "benefit" in the lay sense of the term. Among other effects, it would make Chinese products far more affordable in the United States – enabling Chinese producers to achieve much higher export volumes and revenues.

But "benefit" in the ASCM has a technical meaning. If the financial contribution consists as suggested above in the government providing or purchasing goods (Article 1.1(a)(1)(iii)), then the likely standard for whether a benefit exists is whether the government is receiving less than (or providing more than) "adequate remuneration." (This standard appears in ASCM Article 14, and so applies directly in CVD cases, but would also likely inform the benefit analysis in a case brought directly under the ASCM.) The first resort in checking the adequacy of remuneration is to look at what other sellers and buyers in the same jurisdiction are giving and getting in similar transactions. That inquiry sheds no light here, however, as there appears to be no separate private market in China for dollar-to-*yuan* exchanges at privately-negotiated rates. It is also possible, in certain circumstances, to look outside the jurisdiction for evidence of a market value (the "cross-border" issue litigated with so much fanfare in the *Softwood Lumber* case), but that doesn't help here either since there appears to be no jurisdiction in which dollar-to-*yuan* exchanges are occurring at rates other than the rate set by the Chinese government.

So, to conclude that the remuneration is incorrect here would require resort to analytical techniques never before used in any case of which I am aware. The legal and psychological challenges are formidable. A WTO panel might be reluctant to hold that the one observable dollar-to-*yuan* exchange rate on earth is simply wrong – no matter how many economic studies can be marshaled in support of this view.

And there is also the question of what to make of the various indications that currency misalignment – or at least manipulation – is an area of shared WTO and IMF competence. Topping this list is GATT 1994 Article XV ("Exchange Arrangements"), and particularly Article XV:9(a) which states that "nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the {IMF} …." Article XV seeks to promote coherence between WTO and IMF rules and actions. Like antitrust authorities in different jurisdictions, they should refrain from imposing mandates that are inconsistent (one requiring "X" and one prohibiting "X"), and to the extent possible, conduct examined and approved by one organization should not be condemned by the other. At minimum, Article XV would seem to require close consultation with the IMF in making any formal judgment (in a WTO dispute settlement case or otherwise) regarding misalignment of the *yuan*.

That said, Article XV:9(a) is not a solid shield. The fact that IMF-compatible currency arrangements are presumptively GATT-consistent does not mean that they are presumptively ASCM-consistent. The ASCM is a distinct WTO agreement, setting out numerous obligations additional to those in the GATT itself. (This relationship between the GATT and other closely related WTO agreements has been extensively addressed in the safeguards context.) Additionally, it seems possible that enforced undervaluation of a currency can result in a subsidy under the ASCM definition without necessarily qualifying as "currency manipulation" as defined in the IMF Articles of Agreement. For instance, as noted by the CCC, currency manipulation for IMF purposes includes an "intent" requirement not present in the ASCM.

Characterizing the financial contribution as the provision of a (currency hedging) service leads to a different and possibly easier "benefit" analysis. Such services normally cost money, sometimes quite a lot. Strict governmental control of the exchange rate – even if there is now a narrow band in place rather than a straight peg -- does appear to shield Chinese exporters from the expense of hedging against foreign-exchange losses or purchasing guarantees to guard against exchange-rate fluctuations. As far as I can tell, exporters pay nothing for this service. "Nothing" might well be characterized as "less than adequate remuneration." Indeed, if the currency regime really does include this feature, it might even be considered a *per se* ASCM violation under item (j) of the *Illustrative List of Export Subsidies* (ASCM Annex 1), which identifies as an example of a prohibited export subsidy "{t}he provision by governments … of exchange risk programmes, at … rates which are inadequate to cover the long-term operating costs and losses of the programmes." Although apparently not labeled as an exchange-risk program, China's currency regime may function as one.

There are, admittedly, other ways to look at the "benefit" issue. Pending legislative proposals, for example, aimed at confirming the U.S. CVD law's applicability to the Chinese currency regime, would amend current statutory provisions on "benefit" to provide that a benefit exists "in the case of exchange-rate manipulation …, if the price of exported goods is less than what the price of such goods would be absent the exchange-rate manipulation." *See, e.g.*, H.R. 5043, section 402 ("Clarification to Include Exchange-Rate Manipulation as Countervailable Subsidy Under Title VII of The Tariff Act of 1930"). This different conception of benefit appears to flow from a different characterization of the financial contribution.

If there is a subsidy, it is probably export-contingent. A subsidy (financial contribution plus benefit) is prohibited under ASCM Article 3 if it is export-contingent, either in law or in fact. This initially seems like a stretch in the case of a subsidy (assuming now that one exists) that is equally available to, and given to, *anyone* who has occasion to exchange dollars for *yuan*. But Chinese exporters might qualify as a discrete group of beneficiaries who can *only* get the subsidy by exporting. As in the *United States – FSC/ETI* case, this may be enough to support a finding of export-contingency. The subsidy to these beneficiaries is literally dependent upon the existence of exports; they cannot enjoy or receive it without exporting. Thus, the subsidy can be considered as either expressly (legally) contingent on exporting, or at least as "in fact tied to actual or anticipated exportation or export earnings." See ASCM Article 3.1(a), n.4.

It would of course be useful here to know what the amounts are – what share of dollar-to-*yuan* conversions in a given year is accounted for by exporters who have been paid in dollars, and what share by everyone else (tourists, investors and such). This is another area in which greater transparency on China's part might help to elucidate – conceivably with favorable implications for China – how the exchange regime functions and what its effects are.

If the currency regime confers a subsidy, and if that subsidy is export-contingent, then the specificity requirement is deemed to be satisfied under ASCM Article 2.3. If there is a subsidy but that subsidy is not export-contingent (*i.e.*, if it is a domestic subsidy), then to be actionable it must be shown to be specific according to the criteria in ASCM Article 2.1, and to cause adverse effects according to the criteria in ASCM Articles 5-6.

An actual WTO dispute on this point is unlikely. My informal survey of trade wonks, WTO experts, and China hands suggests that an ASCM complaint against China's currency regime would be, as the *Japan -- Film* case proved to be a decade ago, a "bridge too far" for the WTO. At present it seems to be a bridge too far for the U.S. government. It is worth noting, however, that the *Japan -- Film* case had some salutary results which both preceded and followed the disappointing WTO panel decision. Japan modified or repealed some measures along the way, taking them "off the table" as far as the dispute settlement case was concerned. And Japan also made numerous commitments before the WTO panel regarding how it would apply measures that remained on the books. These commitments played a role in the panel's decision to side with Japan. They also influenced Japan's later behavior, particularly when the U.S. government made clear its intention to monitor Japan's compliance with them over time. Market access did improve. It didn't look like a "win," but in many respects it was. Maybe there is a lesson here.

III. Considering Subsidies in Investment Review

A final category of potential responses involves taking subsidies (or subsidy allegations) into account in the Exon-Florio investment screening process.

"Investment subsidies" present a tricky issue. Foreign direct investment ("FDI") is generally good for the United States; we need lots of it given our public and private (dis)saving rate. I suspect that if one were to look across the last 50 years of incoming FDI, and then mentally subtract all those investments made by entities that had received government subsidies, the total would shrink substantially. Would we be better off in that hypothetical scenario? I doubt it. In principle, FDI by subsidy recipients seems to be just as beneficial as any other type of FDI.

How to square this view with a general support for strict subsidy disciplines? Subsidies are, in general, wasteful and misguided. But there is a reason for having different rules for goods trade and for investment – why we have never had a rule disfavoring incoming investment by subsidy recipients. When foreign subsidies result in low-priced imports, there are both winners and losers on the U.S. side: winners who get cheaper goods, losers forced to try to compete at the subsidized price level. But when foreign subsidies result in U.S. assets being bought for a higher price than they would otherwise attract, it seems to me there are normally only winners, no losers, on the U.S. side, and thus no basis for any public policy response related specifically to the subsidies.

Foreign government *ownership* of an investor is a different matter. Government ownership and subsidies often go hand-in-hand, but not always. Government ownership is more clearly connected to the national security focus of an Exon-Florio review. The national security arguments in an Exon-Florio case – including one where the foreign investor is Chinese -- are what they are. I don't think those arguments derive any added force from the presence (or alleged presence) of subsidies. ("Alleged presence" being more appropriate because even a minimally rigorous subsidy analysis would be impossible in the tight time-frame applicable to CFIUS reviews.)

IV. Effectiveness of WTO Subsidy Disciplines

While the U.S.-China trade relationship does not lack for bilateral issues, China's WTO membership is pulling an increasing share of issues into the WTO forum; particularly where subsidies are concerned, WTO rules will largely determine the form and substance of any U.S. response in the future. Accordingly, anyone concerned about Chinese subsidies and their effects on U.S. economic interests must necessarily be concerned about the effectiveness of WTO subsidy disciplines.

Unfortunately, there are reasons to be worried here. ASCM reform proposals tabled so far in the Doha Development Agenda negotiations have overwhelmingly favored weakening existing multilateral disciplines and the CVD anti-subsidy remedy. Members have tabled proposals aimed at narrowing the range of prohibited subsidies, at "green lighting" broad categories of aid, at loosening the already-loose constraints on export credit agency operations, at making it harder to demonstrate "specificity" in subsidy cases, at making it harder to act against "upstream" subsidies, and at eviscerating the CVD remedy which to date has been one of the few effective deterrents to trade-distorting industrial subsidies. Not all of these proposals are sure to win approval, and there is some pressure in the opposite direction; the U.S. government, for example, did recently table a useful proposal relating to prohibited subsidies and subsidy notification requirements. TN/RL/GEN/94 (Jan. 16, 2006). But the weight of proposals in this area seems to reflect a collective recoil from the disciplines agreed in the Uruguay Round rather than a determination to see those disciplines solidified or extended. (For details, see "WTO Subsidy Discipline: Is This the 'Retrenchment Round?'" in Volume 38(6) of the *Journal of World Trade* (December 2004).)

Any weakening of the WTO rules will narrow the already-limited range of options available to the U.S. government when seeking to respond, in the future, to dislocations caused by Chinese industrial subsidies.

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It has been a great honor to appear before the Commission, and I look forward to your questions.

PANEL V: Discussion, Questions and Answers

HEARING COCHAIR WESSEL: Thank you. Chairman Wortzel.

CHAIRMAN WORTZEL: I have a question for each of you. Mr. Price, from 2002 to 2005, Chinese steel production increased from 126 million tons to 348 million tons. You cite that as a 175 percent increase in five years, and you say it came from 800 mills. So I want to know how they did that. Did they increase capacity? Did those mills increase from 800 to I don't know 1,600? Did they produce new manufacturing equipment inside China to modernize the mills and increase productivity?

Did they buy foreign production equipment to increase their productivity or did they simply make people go to work everyday and actually do something, not put their head down on a desk? Did the government direct people to go to work and you're actually going to produce steel, and then subsidize the production of that steel by sending money into the company through loans or anything else? That's the question. How did they do it? Where did that increase come from?

Mr. Magnus, you made a very interesting statement about the currency value perhaps would come out at around five to the dollar. You said should the Chinese currency be at five instead of 8.02? I found that interesting because when China had two forms of currency, foreign exchange certificates, the FEC actually was at five, and I think it was somewhere between 1992 and 1995 that they said, oh, we're getting rid of this FEC. We're pegging at 8.24 or whatever it was.

Maybe the five made a lot of sense in the international market, but have you looked at whether that really ought to be the rate today?

That's it. Thanks.

MR. PRICE: Chairman Wortzel, thank you for your question. The short answer it's a little bit of all of that. The Chinese government, first of all, if you stop and think about expanding your capacity at that rate, you could not permit that in any developed country. It just would not be permitted from an environmental standpoint, and it points to one of the issues that you've run into, lack of environmental compliance being a subsidy.

One of the issues that developed here was that the Chinese government in several of its prior steel plans made a deliberate effort to go out and develop this industry.

They did so by, one, focusing on a few champions and starting to invest heavily in those champions. Now, that had the result of many me-too effects in some of the provinces because every province wanted to keep up with the Jones out there.

So you had a rapid expansion of capacity in a handful of companies. So you have a lot of smaller companies out there that are still small and very small, but you see a number of companies out there of a moderate size, approximately 20 Chinese steel companies are in the top 80 in the world. One is currently in the top ten in the world.

They bought facilities that were closed down elsewhere in the world as essentially being inefficient, often 20, 30, 40, 50 year old facilities were bought and moved over to China without putting new pollution controls in them.

They in some cases bought state-of-the-art technology increasingly, but they also have benefits to their own equipment builders and to companies to use domestically produced equipment and, lo and behold, number of the equipment producers that on the world market level are complaining about their equipment essentially being knocked off. I know that shocks everyone here.

Not a lot of American steel mill equipment builders so it's mostly the Germans and the Italians and the Austrians who are complaining and the Japanese here.

They did this through government grants, loans that were never paid back, substantial massive investments. No equity market, no debt market in a normal market context could work efficiently enough to build capacity like this.

They would all have hesitation in doing so because the risks are so enormous. Well, there is no risk if the government is just going to forgive the debt at the end of the day, which is what has happened here. So you have this enormous build up that is of state design and you still have an industry where every single major producer at this point is majority state-owned, and so just tremendous benefits doled out.

They viewed steel as a strategic asset. They will not allow many of their current steel companies, the larger ones, any of them, to be acquired by a foreign acquirer because they view it as a strategic industry.

The reason why is because it is the backbone for much of the build-out. Now, some of it is domestic build-out, but a large part of it is export-oriented production or for parts that will eventually be exported out of China.

So this monster that has been built is just not something that would exist if you had a market building this approach. Would China have a steel industry? Of course. Would it have probably the largest one in the world today? Actually it probably would. Would it be its current size? Absolutely not. Would it be its current shape? Absolutely not. Would the world steel market be very different today? Yes. Would there be substantial exports into China? Yes. Would there be fewer Chinese exports into the world's steel market or no steel exports? Probably at this point.

MR. MAGNUS: On the five yuan to the dollar, I haven't done empirical work in many years.

CHAIRMAN WORTZEL: Neither have I.

MR. MAGNUS: I'm a little closer than some in that I've actually read some of the economists' studies that have produced this range of estimates about how severe the undervaluation is. But that figure was just borrowed from the China Currency Coalition, who I think just did some math and said, well, if it's at eight and if it's 40 percent overvalued, it may belong at five.

CHAIRMAN WORTZEL: Very coincidental that that's where it was.

HEARING COCHAIR WESSEL: Let me ask a question about the capacity issues. I believe I read somewhere that your figure was 338.

MR. PRICE: 348 was production. Capacity is actually much higher in China.

HEARING CO-CHAIR WESSEL: My understanding is they are close to 400 capacity at this point.

MR. PRICE: Yes. There is a great mystery as to what the total capacity figure in China is right now. The published numbers that you will see are widely acknowledged including by Chinese government officials in more or less private conversation with U.S. trade associations and U.S. government officials, to substantially understate actual capacity that is available. And China has substantial excess capacity at this point.

HEARING COCHAIR WESSEL: Earlier today and some weeks ago as well, we heard about the administration's Top-to-Bottom Review, and Tim Stratford, who was here this morning. One of the components of that, as I'm sure you're aware, is the Steel Dialogue that's going on. I think we had a Steel Dialogue at the OECD some years ago that yielded no result.

What are your expectations about that Steel Dialogue? Has AISI been consulted at all on that? And if that dialogue doesn't yield the result, what are our options? What do we do?

MR. PRICE: Yes, I'm quite familiar with that dialogue. The dialogue is really at very early stages at this point. AISI and SMA are very involved in that dialogue and providing information to the administration. I would say while optimistic, our optimism is tempered by reality here. The reality to us is that talk is cheap.

Action really counts, and ultimately unless the administration is willing to take action on a number of fronts, including the steel front, including potential actions relating to subsidies at the WTO, for this industry, and frankly multiple other industries, this process is going to continue.

HEARING COCHAIR WESSEL: You indicated that AISI is doing a steel subsidy study. I have to say that in putting this hearing together today, one of the things we found is the lack of specificity on the subsidy issue. Probably the most comprehensive work was done by the American Forest Products and Paper Association which released their study about two years ago.

A question for both panelists. How specific is your study going to be and where does that lead us in terms of the ability to take action? We heard earlier today, and John talked about the Georgetown Steel case, and the legislative legal morass we're in now as to whether we can take action or not.

If your study shows specific subsidies, can we act?

MR. PRICE: It depends on what the precise nature of the action will be. Let's start with the basics. China is not the most open place and it is rather a difficult place to research the actual nature of the subsidies.

As Mr. Magnus and I can tell you from various issues in steel over the years, when we were dealing with the Europeans, frankly you opened up the annual reports and you know the subsidies were all called out in French or in German or whatever else was there. You could look up their legislation. Everything was pretty transparent and you could go out and easily identify them.

That is a far more difficult task in China where a lot of the subsidies are not called out in public. I would say that we are gathering as much information as we can. Will we have excellent examples of various types of subsidies with specific examples? Yes.

Will it be a comprehensive list of who the recipients are and the exact amounts? No. I think that was true with some of what AFPPA found, frankly. Is it enough to take action? Perhaps. I think the answer is where there is a will, yes, it's enough to take action.

Then the question is the U.S. government's willingness to do so and being sufficiently assertive in that regard.

MR. MAGNUS: Two cents on that. In terms of taking action, if you find subsidies, and you can show that they are in a prohibited category, then you can take action. The remedy with respect to export-contingent subsidies works pretty well. The remedy with respect to all other subsidies doesn't work very well unless you're literally shooting fish in a barrel as was happening in the cotton case, much as I hate to say it.

Leaving that aside, though, it's not a very useful remedy at all, and that makes it all that much more important to be able to land in the export and prohibited subsidy category which is one of the areas where there is a threat to the current rules. In the negotiations right now, there are a number of WTO members who want to make it harder to show export contingency. This would throw a great many more cases, which are right on the cusp, out of the "prohibited" category and into this rather useless "actionable" category.

MR. PRICE: Right.

HEARING COCHAIR WESSEL: And the U.S. has not fielded enough papers, as I understand it, to respond to these negotiations; is that correct?

MR. MAGNUS: Yes, and the phenomenon you're describing is particularly true in the antidumping area.

HEARING CO-CHAIR WESSEL: Correct.

MR. MAGNUS: In the subsidies area, everybody has failed to come across with the exception of the couple of WTO members who really have a compelling reason to want to weaken the disciplines and loosen the shoelaces a little bit, and they're the only ones that have really been heard from so far.

HEARING COCHAIR WESSEL: Thank you. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Just to finish up on a point from the last panel. President Hu and Premier Wen Jiabao both went to the big science conference that took place earlier this year in China, emphasizing how important it was for China to be emphasizing science and technology and moving up the food chain. They're not content to be the low-tech producer. They have a plan and they have a strategy, and they're putting a lot of effort in moving up pretty quickly.

Mr. Magnus, you say you don't understand why we haven't had a test case. I think we all wonder why we haven't had a few test cases on China as well. I'll tell you my impression and I want to see if you confirm this.

I think USTR has created WTO, and they find it's perfect, and they don't want to bring cases that show that it doesn't work the way they hoped it would work. Therefore, they keep talking about bringing cases but don't bring them. Do you share that same kind of impression?

MR. MAGNUS: I do think the government has been unreasonably reluctant to bring cases that were promising, if in their view they didn't look like an actual slam dunk. The point I was making about a test case in my statement had to do with a countervailing duty complaint by a U.S. industry testing to see whether Commerce would actually accept it this time.

COMMISSIONER MULLOY: Okay.

MR. MAGNUS: But I do agree with what you say about resort to WTO dispute settlement.

MR. PRICE: I would second that. The constant refrain you hear from USTR if you bring a potential case to them is we want a perfect case. It has to be so perfect that there's almost no chance of losing.

I'll tell you, as a person who litigates countervailing duty cases on a regular basis, and as almost any litigator will tell you, there is almost no such thing as quote-unquote "the perfect case" out there.

So you have to be willing to take some on and sometimes you're going to win, and sometimes you're going to lose in this process, but I think pressing China is of critical importance in the WTO.

COMMISSIONER MULLOY: Mr. Magnus, you were talking about how this exchange rate mechanism works. If you're an American company with operations in China and u ship goods back to the United States and make dollars, do you have to turn those into the Chinese government for yuan?

MR. MAGNUS: That's my understanding. In that context, you're a Chinese exporter like any other Chinese exporter.

COMMISSIONER MULLOY: So that would be an incentive then to keep replowing money back into the Chinese economy?

MR. MAGNUS: It would. Maybe what you're getting at tis that if the subsidy is an undervalued yuan, it's available to everybody who comes along and trades dollars for yuan. Meaning also, investors, tourists. And so that's one of the reasons why there's some question whether it would be found to be export contingent, which as I said a moment ago is so important if you're going to challenge a subsidy, you don't wind up in that category. Then you’ve really got a tough row to hoe.

COMMISSIONER MULLOY: You mentioned CFIUS and the subsidized investment like CNOOC when it was going to take over Unocal and was getting subsidized financing from the Chinese government.

I was involved when we wrote CFIUS in 1988 and then when we amended it in 1992 when I was with the Senate Banking Committee staff. We held hearings in 1992 because Thompson Electronics was going to buy some company, and that was a government owned French company. The hearing said if it's a government-owned company or controlled, it may not be a market motive that's driving the transaction. It could be a non-market motive, and therefore that those are the ones you look at even more critically because there may be some political or security reason for that type of transaction.

That led to the Byrd-Sarbanes amendment in 1992 that said if it was a government-owned corporation, the presumption is you do the investigation and not just kick it out after the first 30 days.

MR. MAGNUS: Commissioner Mulloy, I have no disagreement with that. My only point is that you need to distinguish government ownership from subsidies and subsidy allegations. I think here's a good mental exercise. If you look back over 50 years at all of the incoming direct investment, foreign direct investment, and then mentally you subtract of that investment that we received that came from investors who had received government subsidies, I'll bet you'd be lining out a large chunk of it, and I question whether we'd be any better off in that parallel universe.

Ownership is a different thing all together. I can understand where that has a national security angle to it. But subsidization doesn't necessarily do the same thing. I certainly did not mean to speak to the question of incoming investment by government-owned investors.

COMMISSIONER MULLOY: So, if it's a government-owned or controlled acquisition, you wouldn't apply that type of thinking to it?

MR. MAGNUS: Not at all.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR WESSEL: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you very much, Mr. Chairman, and thank both witnesses for your very good testimony. I have a question I want to explore with you, Mr. Price on the steel industry in China.

I think you used the word "knocked off technology." What I'm concerned about is the whole question of IPR violations, downstream dumping or whatever you want to call it, the intermediate stages of the industrial process where the equipment has been knocked off from an American or Western or other firm where the R&D costs are not absorbed by the Chinese steelmaker, but basically free as a result of that being copied.

If you put that together with the fact that all of the steel industry, all of the companies in China are state-owned, then, of course, there a question arises as to whether this is a government policy? Is the IPR issue here something that we need to be concerned about in terms of this as a government development policy by knocking off technology and IPR violations in the downstream, midstream industrial area?

Do you know much about the extent of that, and whether there are measurable ways to look at IPR violations in terms of the industrial process in the steel industry?

MR. PRICE: My knowledge of the knockoffs frankly is from trade press, and that has not been systematic. I have not been in a position to systematically analyze that, and I am not an IPR expert. So, obviously you probably have heard more from other IPR experts out there who could give you all kinds of opinions.

What I would say, though, going back to your questions and Commissioner Houston's questions of the last panel on technology, is that this is not just a low tech or mid-tech issues. You don't graduate engineers in U.S. schools if there are no jobs for them in their hometown or in their local communities or reasonable communities for them to go to assume.

What we are seeing is wholesale transfer of assets from the U.S. to China, and in this regard, the government policies on IPR or lack thereof in China are indistinguishable from the government policies to essentially move industrial base from the U.S. and Europe and Japan to China.

As those things happen, you lose your IPR, you lose your intellectual base over time. It doesn't mean that we have no intellectual base. It just means that you're going to be losing your future. You're going to have less out there for us to capitalize and the significant rents that we currently earn in IPR and the benefits we currently have as a society will diminish sharply over the next decade or two because we are not, in essence, re-capitalizing manufacturing, which is the source of so much of the R&D out there and creates the job engine that our kids go to school for to service. So this is a very negative cycle that has developed out here.

COMMISSIONER D'AMATO: Thank you. Do you have anything to add to that?

MR. MAGNUS: I don't. Thank you.

COMMISSIONER D'AMATO: Okay. Thank you.

HEARING COCHAIR WESSEL: Just as a qualifying before I turn to Commissioner Blumenthal. You talked about the West German production equipment that's being knocked off during your testimony; correct?

MR. PRICE: Yes.

HEARING COCHAIR WESSEL: So that would be the downstream dumping, in part. If we have to pay $30 million for a machine, you know, they can knock it off and produce it for two, it means their production costs are that much lower.

MR. PRICE: Oh, yes.

HEARING COCHAIR WESSEL: So it is downstream dumping that's really not being caught in the whole IPR debate that we need to look at.

COMMISSIONER D'AMATO: Nor measured.

HEARING COCHAIR WESSEL: Nor measured, yes.

MR. PRICE: Absolutely. I agree with you. It's all part of how do you give yourself this enormous advantage, and I have every confidence that the Chinese will have great IPR protections once 20 years from now once it's essentially their IPR that they're going to be protecting.

HEARING COCHAIR WESSEL: They have them already for the Beijing Olympics. There is yet to be any identified violation of the mascot for the '08 Olympics.

Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes, thank you very much, to both of you. I have a question for Mr. Magnus. Your bio states that you advised the government of Beijing; is that right?

MR. MAGNUS: I did. I was invited under the auspices of the Asian Development Bank and basically I was locked in a conference room with, it was called MOFTEC at the time--with their officials for about a week, as they tried to get their trade remedy laws ready for WTO accession.

COMMISSIONER BLUMENTHAL: From a Chinese perspective, we've heard a lot of testimony today about what China should do, what's rational to do. We heard, for example, in the last panel that part of the solution to this export subsidy currency undervaluation is an increased fiscal spending, domestic demand. We all have the solutions I suppose.

Obviously they don't see it that way. Right? Obviously they probably see the huffing and puffing back here about a number of things, and maybe are responsive and maybe are not. But obviously, they don't see things the way we do about what they should do and what's rational to do and what's better for their economy. I wonder if you have any insights as to why that is?

We, for example, got a briefing that if they just transitioned from, as I said, more domestic spending and more domestic demand, it would take care of their problems with surplus labor and therefore the exchange rate can float.

But they're not doing it. So, having spent some time with their government, can you please enlighten us as to their perspective on all these things we think they should be doing?

MR. MAGNUS: I wish that I could. The folks I was being confined with in this conference room were mostly young people who were responsible for measures that were designed to achieve WTO conformity on a whole range of their domestic legislation and I don't think any one of them had any responsibility on the currency issue.

I can speculate that, you know, they reckon they've lifted a couple hundred million people out of poverty in relatively short order, and so they probably aren't doing anything all that drastically wrong. And, you know, they may also believe that if the United States government wants something, they're probably supposed to want the opposite of it.

COMMISSIONER BLUMENTHAL: Fair enough.

HEARING COCHAIR WESSEL: With that, we will close the panel and close today's session and thank our patrons, the Science Committee, that generously gave us this room. We thank the panelists for participating. We're closed subject to the call of the chair.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]

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[i] Brad Setser. The Chinese Conundrum: External financial strength, Domestic financial Weakness, at page 16. October 31, 2005. RGEmonitor website at [http://www.rgemonitor.com/redir.php?sid=1&tgid=10000&cid=108028].

[ii] *Id*

[iii] Reported in Cao Desheng, "Diseases at Work Haunt Migrant Workers," China Daily (February 17, 2006)

[iv] U.S. Department of State, Bureau of Democracy, Human Rights, and Labor, Country Report on Human Rights 2005: China (March 8, 2006).

[v] Evan Osborne, "Some Economics of Chinese Prison Labor," Wright State University and Osaka University Institute of Social and Economic Research (undated); Philip Pan, "China's Prison Laborers Pay Price for Market Reforms," Washington Post (June 14, 2002)..

[vi] Congressional-Executive Commission on China Roundtable on Forced Labor (June 22, 2005).

[vii] See, e.g., Minqi Li, "Aggregate Demand, Productivity, and 'Disguised Unemployment' in the Chinese Industrial Sector," World Development vol. 32, no. 3 (March 2004) at pp. 409-425.