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Does China's State-Owned Sector Follow Trade Rules?

Presentation of
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Members of the Commission and Co-Chairs, my name is Thomas Howell. I am a partner in the International Trade Group of the Washington DC offices of Dewey Ballantine LLP, an international law firm. I have been working on matters involving China since 1979. I appreciate this opportunity to appear before you today.

My panel has been asked to address the question of whether China's state-owned sector follows trade rules. Since acceding to the WTO China has undertaken a sweeping effort to bring its laws and measures into conformity with WTO rules. While this effort has brought about a significant liberalization of trade and investment policies, the U.S. government continues to express concerns about the pace of China's WTO implementation. With respect to China's state-owned enterprises (SOEs), state ownership of a commercial enterprise, standing alone, is not inconsistent with WTO rules. However certain government policies and practices commonly associated with China's SOEs can cause market distortions and injury to private enterprises and in some case may be inconsistent with WTO rules. I would like to devote my presentation to three of the most important categories of such measures which are used to support with China's SOEs which for the most part are not inconsistent with WTO rules, but are nevertheless potentially problematic for U.S. industries -- subsidies, government-sanctioned restraints on competition, and preferential government procurement.

China's State-Owned Enterprises

When the Communist Party assumed power in China in 1949 all large producing entities became governmental organizations, the so-called state-owned enterprises or SOEs. Since 1978, when China's leadership committed the country to a course of long run economic reform, restrictions on the formation of private enterprises have been relaxed, some SOEs have been privatized, and foreign enterprises have been encouraged to form joint ventures with Chinese firms and to establish stand-alone local enterprises. In many parts of the economy a vibrant private sector has emerged. SOEs continue to dominate a number of sectors, including metals, mining, banking and energy. The conventional wisdom is that these SOEs are inefficient, overstaffed and poorly managed, and technologically backward, and in many cases the conventional wisdom is true.

However in recent years the Chinese government has been engaged in a comprehensive effort to reform the SOEs and to groom a number of them as "national champions" capable of competing at the world level in terms of scale, managerial competence, and technology. In 2003, the government created the State-Owned Assets Supervision and Administration of the Sate Council (SASAC), an entity charged with owning and supervising designated SOEs. Ownership of 196 SOEs has been transferred from government ministries to SASAC, and at the regional level branch SASACs have assumed control of some SOEs from local governments. SASAC has undertaken to rationalize management of the SOEs, reduce corruption, and protect the economic decisionmaking of the SOEs from interference by central and local governments. Some of these SASAC-held SOEs, such as Shanghai's Baosteel Group, have emerged as world-class competitors with competent managers, advanced technology and production processes, and sophisticated products.

These reforms are sometimes seen as transitional steps on the way to eventual SOE privatization. While this is partially true, China's leadership clearly intends that certain key industrial sectors will be more or less permanently dominated by SOEs as a matter of state policy. In December

2006 SASAC issued a notice stating that the "state-owned part of the economy shall have absolute control over important industries and key fields that are the vital arteries of national security and the national economy, "including armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping." SASAC indicated that in these sectors "state-owned assets should expand in volume and be optimized in structure, and some key enterprises should grow into leading world businesses." (*Guo Ban Fa* No. 97, December 5, 2006). Similar statements by other government organizations have identified additional sectors to be retained under state control, such as the steel industry.

The WTO agreements, including the General Agreement on Tariffs and Trade (GATT) contain many rules premised on the notion that reducing government interference in the operations of private enterprises is beneficial and conducive to the world's economic welfare. But there is no prohibition, per se, on government ownership of an enterprise. Rather, the WTO system establishes constraints on the common mechanisms governments can use to promote individual enterprises whether publicly or privately owned -- import protection, subsidies, discriminatory taxes and domestic regulations, preferential government procurement, and so on. The longtime members of the WTO have learned to operate within these parameters and many of them have demonstrated that it is possible to channel massive state support to individual enterprises without running clearly afoul of GATT/WTO rules. Since the inception of the GATT "National champions," usually government-owned, have been promoted in Britain, France, Italy, Spain, Brazil, Mexico, Korea, and many other countries. There are many parallels between China's current promotion of key SOEs and those earlier efforts.

The challenge U.S. policymakers and U.S. industries face from China's SOEs is similar to that which was presented by SOEs based in Europe, Asia and Latin America. "National champion" SOEs benefit from an array of government measures intended to confer competitive advantages on individual enterprises. For the most part, while we may not approve of these promotional policies, they are not prohibited outright by WTO rules. Instead the WTO system provides institutional mechanisms for members to take remedial action when certain kinds of government promotional policies or industry trade practices cause economic injury to the industries of another member. This includes the ability to invoke WTO Dispute Resolution Procedures or to take action under national countervailing duty, antidumping and safeguards legislation. Although Chinese measures have already been subject to several WTO challenges, I believe that over the long run the U.S. trade remedies will remain the principal form of recourse available to U.S. industries confronting market distorting policies benefiting China's SOEs.

Subsidies

One of the most problematic aspects of China's SOE policies relates to the various forms of financial support SOEs receive from the government. China's equity and bond markets are not well developed and most SOEs must rely on government-owned banks for financing. The government controls interest rates at sub-market levels, creating an excess demand for credit, and the banks typically channel loans to enterprises designated by the government rather than to areas where the highest returns can be achieved. (A similar practice was at one time found in Japan and Korea.) Historically many of these loans have become nonperforming and have been written off or converted to "equity" without increasing the governments' proportion of ownership. Such politicized lending has characterized the operations of not only the country's

three "policy banks" but its four main so-called "commercial banks," which, despite their name, continue to direct their loans toward the SOEs.

From the perspective of China's trading partners, private enterprises must compete against Chinese SOEs that may be considerably less efficient and productive, but which enjoy massive government financial support. This dynamic occurred in the European Community in the 1970s and 1980s and the result, both inside and outside of Europe, was that massive overcapacity was created and competition by subsidized SOEs drove more efficient private firms into financial distress and in some cases, out of the market altogether. As the presence of China's SOEs in international markets grows, this phenomenon may recur.

The WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") prohibits subsidies which are contingent on export or which are contingent on the use of domestic or imported goods. But the vast preponderance of government financial assistance to China's SOEs, however, does not fit in either category. Most of these subsidies are so-called "domestic subsidies" which do not violate WTO rules but which are actionable under some circumstances when they cause economic injury to producers in another member country. WTO Dispute Resolution procedures can be invoked when subsidies cause "adverse affects" or "serious prejudice" to the interests of another member, but for whatever reason this remedy has not proven an effective discipline on subsidies.

The most common remedial measure with respect to injurious subsidies has been the application of countervailing duties by member governments, which is authorized by Part V of the SCM Agreement. To be clear, a subsidy which is subject to countervailing duties is not "illegal" or in violation of WTO rules. Most countervailed subsidies are domestic measures permitted under WTO rules which are found to have caused "material injury" to producers in another country. Under those circumstances, the WTO authorizes the country whose industry has experienced injury to apply a duty calculated in a manner which is intended to offset the effect of the subsidy and, in effect, to level the competitive playing field. In a reversal of policy, the U.S. government recently ruled that countervailing duties can be applied to subsidized imports from China, and the countervailing duties currently represent the most viable existing response when Chinese subsidies injure U.S. industries.

Administered restraints on competition

Competition policy has commonly been used as an industrial policy tool in industrialized countries. In the 1960s Japan used its Antimonopoly Law as a defensive weapon to protect domestic industries from "mammoth foreign capital." In the 1970s and 1980s in the European Community and Japan, cartels were commonly sanctioned by government authorities to enable depressed industries to stabilize prices and curb what was sometimes called "excessive competition." By reducing market pressure on domestic producers, cartels prevent competitive shakeouts from occurring and lead to excessive capacity and dumping in export markets.

Since the mid-1990s China has utilized cartels in SOE-dominated industrial sectors to limit "disorderly competition" (*exing jingzhang*) and to help domestic producers stabilize and in some cases increase prices. Typically these arrangements involve the establishment of collective restraints on output for domestic sale, but with no restraints on production for export.

Compliance is monitored by industry trade associations and government officials. The government sometimes threatens to cut off bank loans to enterprises that do not comply with agreed output restraints or that engage in unauthorized discounting. Historically similar cartel-based output restraints were utilized in Japan, Europe, South Africa and other countries, and have almost invariably led to dumping in international markets during recessionary periods. This is a likely consequence of the application of similar policies in China.

China is currently in the process of drafting an Antimonopoly Law which will prohibit cartel-type activities like price fixing and collective restraints on output and sales (Article 7). However, Article 10 of the draft law provides for exemptions from these prohibitions "during the period of economic depression, to moderate serious decreases in sales volumes or distinct production surpluses." In effect this is a provision for legalizing anti-recession cartels, and, if the European and Japanese precedents for such policies are followed, the exemption will find widespread application in SOE-dominated heavy industries suffering from overcapacity.

The WTO has no rules governing competition policy, reflecting the dissensus that has prevailed on this issue in the multilateral community since the inception of the GATT. China will thus enjoy broad leeway in using cartels to protect domestic industries from competitive pressure without running afoul of any WTO rules. The principal policy tool available to U.S. industries affected by dumping is not WTO dispute settlement but application of duties pursuant to the U.S. Antidumping Law.

Dumping, like most forms of subsidization, is not "illegal" under WTO rules, although Article VI of the GATT provides that dumping "is to be condemned" if it cause or threatens material injury to an industry of another member or materially retards the establishment of a domestic industry. In such cases GATT Article VI and the WTO Agreement on Implementation of Article VI of the GATT authorize members to impose duties calculated to offset the margin of dumping.

Preferential procurement

Preferential government procurement policies are a common industrial policy tool and at one time were common in Europe, Asia, and the United States. The practice has been sharply curtailed, however, by the adoption of multilateral rules, currently embodied in the WTO Government Procurement Agreement (GPA) committing GATT/WTO members to practice nondiscriminatory procurement with respect to designated governmental entities. When China joined the WTO, it did not accede to the GPA although it accepted observer status with a commitment to accession at an unspecified future date. As a strictly legal matter, Chinese government ministries can take the position that they have no obligation to refrain from favoring domestic enterprises in their procurement decisions. China enacted a *Government Procurement* Law in 2003, Article 10 of which provides that "the government shall procure domestic goods, construction and services," except when the needed items are not available in China, cannot be acquired on reasonable commercial terms, are for use abroad, or are subject to the provisions of other laws.

Moreover, recent actions suggest that the government intends to make expanded, orchestrated use of preferential procurement as a tool to promote the development of indigenous industries. The *Long Range Science and Technology Plan to 2010*, released in 2006, provides that "Rules

governing government procurement should be adopted so that the government will give priority to purchasing high-tech equipment and products and products that domestic manufacturers own their independent IPR." In December 2006 three Chinese ministries jointly released the *Provisional Measures for Accreditation Measures of National Indigenous Innovation Products*. The measures establish an administrative accreditation process so that "domestic innovative products" could be certified and that products so certified "shall be given priority in procurement projects for government and in key national projects that will spend treasury funds." The protectionist intent underlying these recent measures is manifest; the *Long Term S & T Plan* speaks of the need to "stop unscrupulous and redundant imports," and the Accreditation Measures stipulate that consideration be given as to whether the applicants' products can be substituted for imports.

Despite China's nonmember status with respect to the GPA, it does not follow that China is completely free to use preferential procurement as a tool of industrial policy. When it joined the WTO, China gave assurances with respect to the SOEs that these enterprises would "make purchases and sales based solely on commercial considerations, e.g. price, quality, marketability and availability, and that the enterprises of other WTO members would have an adequate opportunity to compete for sales to and purchases from these enterprises on non-discriminatory terms and conditions." (Working Party Report WT/ACC/CHN/49). The government of China also gave assurances that it "would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including on the quantity, value or country of origin of any goods purchased or sold, except in a manner consistent with the WTO agreement." On the basis of these commitments, it would appear that any attempt to extend the procurement preferences policies outlined in the *Long Term S & T Plan* and the *Accreditation Measures* to purchasing practices of the SOEs would be inconsistent with China's WTO obligations.

However China's central and sub-national government entities are not subject to a WTO commitment of nondiscrimination in procurement (apart from an assurance that one foreign supplier would not be treated more favorably than another in procurements open to foreign bidders). Because of the pervasive role of the government in the Chinese economy, these government organizations represent a vast market that is substantially walled off to foreign entry, with a major class of beneficiaries being the SOEs themselves. It can be argued that given China's accession to join the GPA "as soon as possible," the implementation of sweeping new preferential procurement measures that cut against the principles of the GPA is at odds with the spirit, if not the letter of this commitment. The reality, however, is that a successful legal challenge to China's procurement preferences in the WTO is unlikely. Any comprehensive effort to level the competitive playing field with respect to the SOEs will require China's full accession to the GPA and the application of WTO disciplines to China's public procurement policies and practices.

Conclusion

The WTO system establishes a variety of interface mechanisms to address the practical reality that national economic systems differ, with an eye toward mitigating conflicts as these systems came into closer interrelationships with each other. China's SOEs represent a major systemic difference between the economies of the U.S. and China, both of which are now WTO members

and engaged in extensive and wide-ranging trade and investment relationships. In the near term it will be necessary, on occasion, to use WTO-consistent policy measures to offset injury that can occur to U.S. producers. This will require periodic resort to U.S. antidumping and countervailing duty remedies and, possibly, negotiation of new multilateral rules and enactment of legislation or regulatory changes to strengthen those laws. It will require bilateral negotiations and agreements with China to minimize friction. In some cases it may require resort to safeguards measures authorized under the WTO Agreement on Safeguards and the provisions of China's protocol of accession to the WTO. It will require bringing China into the WTO Government Procurement Agreement.

In the longer term the challenges posed to the world trading system by China's SOEs may prove to be self-correcting. Newly-industrializing countries like Brazil, Mexico, Korea and Taiwan have used "national champion" SOEs as a developmental tool, but have scaled back or abandoned government ownership of enterprises as their economies have matured, generally concluding that faster and more balanced economic growth can be fostered by private enterprise.

China may reach similar conclusions, and a lively debate has been under way about the future of the SOEs since the early 1990s. Chinese policymakers recognize that the SOE sector taken as a whole is a drag on the economy and a source of potential friction with trading partners. The banking system channels a disproportionate share of loans (roughly three quarters of the commercial banks' loans) to the SOE sector despite the fact that the SOEs' productivity is approximately half that of the private sector. The result has been the creation of excess capacity in sectors like steel and the diversion of resources into comparatively unproductive enterprises and activities. The drain on the banks represented by nonperforming loans has required periodic bailouts of the banks by the government. Although some SOEs have emerged as powerful international competitors, for the most part this has not occurred in technology-intensive sectors. China may well follow the model of other industrialized economies and seek to privatize or shut down most of its SOEs.