WTO COMPLIANCE AND SECTORAL ISSUES

FRIDAY, JANUARY 18, 2002

U.S.-CHINA SECURITY REVIEW COMMISSION,
Washington, DC.

The Commission met at 9:05 a.m., in Room 124, Dirksen Senate Office Building, Washington, D.C., C. Richard D'Amato (Chairman) and Patrick A. Mulloy (Hearing Co-Chairman), presiding.

OPENING REMARKS OF CHAIRMAN C. RICHARD D'AMATO

Chairman D'AMATO. On behalf of Vice Chair Michael Ledeen and myself, I want to welcome everyone to the 10th scheduled hearing of the U.S.-China Security Review Commission in pursuit of its mandate to link the broad economic and security aspects of the United States-China relationship.

This hearing will complete our scheduled series of hearings, which have been exactly 50 percent on security matters and 50 percent on economic matters in pursuit of the mission to link the two as the mandate of this Commission.

Before I turn over this morning's hearing to Commissioner Mulloy, I want to take this moment to congratulate all commissioners for their commitment and participation in the hearings and work of the Commission. It has been very successful. I think we have averaged 10 of the 12 commissioners in attendance at all of our hearings, which is a very, very high attendance rate. Nearly all have chaired at least one hearing and worked on that, and I congratulate them on the quality of the give and take in the questions and answers.

We have originated some original research which you will find on our website as well as the text of the various hearings posted on our website, and all the hearings will be posted on our website by the early part of February.

This morning, Commissioner Mulloy will chair two panels on the very important matter of WTO commitments on compliance, and without any further ado, I will turn it over to Commissioner Mulloy.

I would also like to congratulate staff on the quality of their work in supporting our hearings, including today's hearing. They have done a very, very fine job of putting together our hearings books.

Commissioner Mulloy?

[The statement follows:]

PREPARED STATEMENT OF CHAIRMAN C. RICHARD D'AMATO

This morning's discussion laid out the significant hurdles China faces in implementing its WTO obligations. Whether China can successfully overcome these hurdles, and how long this process may take, is an issue that will underlie the U.S.-China economic relationship for years to come.

As part of its assessment of the implications of China's WTO accession on U.S. national security, the Commission has sought out testimony from representatives of impacted U.S. industry sectors. In prior hearings we have heard from the steel, aerospace, automotive, agriculture, and electronics industries. Today we will hear from three additional sectors, all of which supported China's accession—financial services, entertainment, and communications. They will enlighten the Commission on both the potential business opportunities they foresee in post-WTO China and the obstacles they face in achieving this potential.

Our first panel of the afternoon will examine the prospects for banking, insurance, and financial securities firms in China. We are pleased to welcome David Hale, Global Chief Economist for Zurich Financial Services and Chairman of the Board of China Online, William Overholt, Senior Fellow at the Harvard University Asia Center and formerly an international banker posted in Hong Kong and Singapore, and Andrew Shoyer, a partner with Powell, Goldstein, Frazer & Murphy who served for several years in legal advisory positions at the Office of the United States Trade Representative.

Our next panel will focus on the entertainment industry and the protection of foreign firm's intellectual property rights in China. We will hear from Bonnie Richardson of the Motion Picture Association of America, Larry Spiegel, President of Appledown Films, an independent production company in Los Angeles, Eric Smith, President of the International Intellectual Property Alliance, and David Quam, General Counsel to the International AntiCounterfeiting Coalition.

The last panel of the day will offer the perspectives of the communications industry. Serving on that panel will be Roger Uren, Vice President for International Affairs at Phoenix Satellite Television, which recently became the first foreign firm to obtain a broadcast license in China, Lyric Hughes, CEO of China Online and an expert on the Chinese media and advertising market, Hurst Lin, U.S. General Manager and Vice President of Business Development for SINA.com, a prominent Chinese Internet service and content provider, Stephen Hsu, Chairman and CEO of Safeweb, a proxy service that allows users to circumvent Internet censorship efforts, and Laura Sherman, Communications Counsel at Paul, Weiss, Rifkind, Wharton & Garrison who previously worked on international telecommunications issues at the Federal Communications Commission and the United States Trade Representative.

The entertainment and communications industries present particularly sensitive issues. The value produced by these industries is to a large degree attributable to the content of their works. To this end, foreign companies face concerns regarding China's willingness and ability to protect their intellectual property rights through enforceable copyright, trademark, and patent laws. Some reports suggest that the vast majority of foreign audio/visual products and computer software sold in China are counterfeit despite enforcement efforts there. In addition, many entertainment and communications works are subject to restrictions on content imposed by the Chinese Government in its attempts to limit the free flow of information. I look forward to a lively discussion with the panelists on these important issues.

With yesterday's hearing on export controls and today's discussion of WTO issues, the Commission has completed ten hearings, evenly split between trade and investment and security issues. We have heard from over 100 witnesses that have generated more than 3,000 pages of transcript. The Commission has no other public hearings presently scheduled during our initial reporting cycle, which concludes with the issuance of our first report to Congress in June. We will of course continue to seek input from relevant government, academic, and private sector individuals where needed to assist us in preparing our report. Should the Commission determine that additional public hearings are necessary, we will notify the public accordingly.

OPENING REMARKS OF CO-CHAIRMAN PATRICK A. MULLOY

Co-Chairman MULLOY. Thank you, Chairman D'Amato.

I am pleased to have been asked by the Chairman and my fellow commissioners to co-chair today's hearing.

Congress established this Commission in October of the year 2000 for the purpose of monitoring and investigating, among other things, the national security implications of the bilateral trade and economic relationship between the U.S. and the People's Republic of China.

We are charged with giving Congress a report by June with our findings and recommendations, if any, for legislative or executive action.

As the Chairman has indicated, this is the 10th hearing that we have held, and today's hearing is the third in which we have looked into issues related to China's accession to the WTO, which in our statutory charter is an issue that we are charged to look into, and how we are organized to get China to live up to those commitments.

Since our last hearing on this issue in August, China has now joined the WTO and is now in the process of undertaking the economic reforms necessary to comply with its obligations.

We have heard in other hearings an array of opinions about what the impact of this would be. Supporters of China's accession to the WTO—and we have heard from Ambassador Barshefsky, Admiral Prueher and others who have argued that it will open up China both economically and politically in ways that are going to be beneficial to American interests. One of the key premises of this argument is that China has both the will and the capacity to comply with its varied WTO commitments.

We have had an opportunity—a number of the Commissioners have been to China, and in our numerous meetings with Chinese officials, they have assured us of their intention to fully comply with their WTO obligations. Nonetheless we recognize that it is going to be a monumental task because they do not have a mature, transparent legal system, and they do not have the judicial and administrative infrastructure that is necessary to meet those obligations.

So that is a key area that we are very interested in and hearing from the government about how we are going to deal with this issue.

The other issue we found was that the central government may have the will and the capacity, but how they get the local and provincial governments to live up to these obligations is another key issue.

For this morning's session, we are very fortunate to have people who are on the front lines in the administration examining how China should be living up to these requirements.

On our first panel, we are going to hear from the Assistant United States Trade Representative in charge of the China policy, Jeff Bader.

Then we will hear from my successor in the Commerce Department, Assistant Secretary of Commerce in charge of Market Access and Compliance, William Lash. And I thank you for being here.

Mr. LASH. I'm glad to be here.

Co-Chairman MULLOY. Our third witness—and we hope he will arrive shortly—is the Acting Assistant Secretary of State for Economic and Business Affairs, Shaun Donnelly.

And then, finally, we will hear from Patricia Sheikh, the Deputy Administrator for International Trade Policy at the Department of Agriculture.

I am going to ask the witnesses if they could please limit their oral statements to no more than 7 minutes. We have a lighting system here that will start with green, keep going, and a yellow, please begin to wrap up, and red, wrap up.

We will again have a 5-minute question period for Commissioners, and again, if you could watch the light, and when it is red, please refrain, and we have got to move it along; otherwise, all Commissioners won't have an opportunity to ask the questions they want to ask.

So if I could turn now to Ambassador Bader and ask him if he could begin his testimony. Thank you.

[The statement follows:]

PREPARED STATEMENT OF CO-CHAIRMAN PATRICK A. MULLOY

I am pleased to have been asked by Chairman D'Amato and my fellow Commissioners to co-chair today's hearing.

Congress established the U.S.-China Security Review Commission in October 2000 for the purpose of monitoring and investigating, among other things, the national security implications and impact of the bilateral trade and economic relationship between the U.S. and the People's Republic of China. We are charged with providing an annual report to Congress with our findings and recommendations, if any, for legislative or executive action. Our first report to the Congress is due this June.

The Commission has held ten hearings to examine the various issues designated in our legislative mandate. Today's hearing will be the third to examine matters related to China's accession to the World Trade Organization (WTO). Since the Commission's last hearing on this topic in August, China has formally entered the WTO and is now in the process of undertaking the enormous economic reforms necessary to comply with its WTO obligations. In prior hearings, we heard an array of opinions about how China's WTO accession will impact the U.S. economy and U.S.-China relations. Supporters of China's accession have argued that it will open up China both economically and politically, in ways beneficial to U.S. interests. One of the key premises of this argument is that China has both the will and capacity to comply with its varied WTO commitments.

In numerous meetings with Chinese officials, members of this Commission have been assured of China's intention to fully comply with its WTO obligations. Nonetheless, this will be a monumental task for China. China lacks a mature and transparent legal system and the judicial and administrative infrastructure that is essential to meeting its WTO obligations. In addition, China must still enact hundreds of new laws to come into compliance. Enactment of appropriate statutes and development of the requisite legal and administrative institutions will be an important indicator of China's commitment, but the key indicator will be China's actual implementation of its new policies. Further, even if the central government is committed to the WTO, it is uncertain whether it has the resources to enforce compliance by reluctant local officials who have a vested interest in the status quo.

During the morning session of today's hearing, which I will chair, we will examine China's ability to meet its near-term and long-term WTO commitments and whether and how the U.S. may be able to play a constructive role in assisting China in this effort. We will first hear from a distinguished panel of representatives from the U.S. Government agencies on the front lines of monitoring China's compliance efforts—Assistant United States Trade Representative Jeffrey Bader; Assistant Secretary of Commerce William Lash; Acting Assistant Secretary of State Shaun Donnelly; and Patricia Sheikh, the Deputy Administrator for International Trade Policy at the Department of Agriculture.

A second panel will present important perspectives on this issue from outside the government. We will hear from Professor Donald Clarke of the University of Washington Law School; Jeff Fiedler, a consultant to the Food and Allied Service Trades Department of the AFL–CIO; Professor Margaret Pearson of the University of Maryland, who served on the Council of Foreign Relations' task force on China's WTO accession; and Terence Stewart, a very distinguished attorney whose law firm—Stewart & Stewart—is preparing a study for the Commission that will set benchmarks for future efforts to monitor and assess China's WTO compliance.

During the afternoon session, which Chairman D'Amato will chair, the Commission will continue its survey of how key industry sectors in the U.S. view China's WTO accession, with testimony from representatives of the financial services, entertainment and communications industries. In addition to market access issues, this afternoon's session will examine the unique challenges facing U.S. entertainment and communications firms as a result of China's nascent intellectual property rights regime and its attempts to restrict the free flow of information.

I look forward to an interesting and productive hearing.

PANEL I: WTO COMMITMENTS AND COMPLIANCE

STATEMENT OF JEFFERY BADER, ASSISTANT U.S. TRADE REPRESENTATIVE FOR CHINA

Mr. BADER. Thank you, Mr. Chairman.

I am pleased to appear before the U.S.-China Commission today to discuss the Administration's perspectives on the United States' trade relationship with China. As the Chairman's letter requested, I will address four topics—China's willingness and ability to comply with its WTO commitments; the interagency process set up to monitor China's WTO compliance; the WTO's so-called transitional review mechanism; and the mechanisms available to resolve trade problems with China, such as dispute settlement.

China's accession to the WTO was a decisive victory for reform in China. In recent years, China's reformers have clearly understood the value and benefits of openness in the economic sphere, and that is why they pursued WTO membership. They know that WTO membership will help them transform China's economy and, many hope and believe, China's society generally, in positive ways.

The Bush Administration, like the previous administration, worked closely with China's reformers throughout the many years of WTO negotiations. Now that the negotiations are over, we want to continue to work with them in this next phase of the process as China embarks on the enormous task of implementing the numerous WTO commitments it has made.

Clearly, implementation is and will be a major challenge for China and its reformers. They must find ways to ensure that recalcitrant ministries, state-owned enterprises, and provincial and municipal authorities, as you indicated, Mr. Chairman, all act in conformity with China's WTO commitments.

The ability of China to meet this challenge and implement its commitments in full will depend on the outcome of several sets of dynamics. One set of dynamics involves the central government's ministries. Some of them are reform-minded and generally understand the benefits of full compliance with WTO rules. The Ministry of Foreign Trade and Economic Cooperation, MOFTEC, which had the lead in the WTO negotiations, is one example. But other ministries, particularly those with regulatory and proprietary functions or with a domestic focus may be less interested in and indeed resistant to full compliance.

In certain circumstances, they will be more inclined to seek ways to protect their own and their constituents' existing rights and privileges, so they will represent a particular challenge to the implementation process.

There will be a similar set of dynamics that we will have to follow closely involving the central government and the localities. We can expect foot-dragging by some provincial and municipal authorities that did not see immediate benefits in complying with WTO rules or that simple do not understand them.

Historically, Beijing's influence over local authorities has been erratic, and at this point, the breadth and extent of its influence vis-a-vis China's WTO commitments remains unclear.

Realistically, we can expect some noncompliance as these internal struggles take place. Through all available and appropriate means, we intend to make clear what China's commitments are, and we will work closely with those institutions and elements in China that can help us obtain compliance.

Given China's importance as a major trading partner and the breadth and complexity of China's WTO commitments, the Administration has set up a comprehensive interagency monitoring effort to determine the extent to which China is complying with those commitments. USTR's China office is coordinating this effort, which is formally overseen by the newly-created Trade Policy Staff Committee, the so-called TPSC, whose mandate will be devoted exclusively to China.

All TPSC agencies have been invited to participate in this newly-created subcommittee, which held its inaugural meeting on December 4, 2001, and we met yesterday for the second time. We expect to meet on a monthly basis.

Our monitoring activities are taking place on several fronts. In China, our State Department economic officers, foreign commercial service officer, foreign agricultural service officers, and customs attaches, are very active gathering and analyzing information, maintaining regular contacts with U.S. business and agricultural associations and companies doing business with China, maintaining a regular dialogue with Chinese government officials in key ministries and agencies, and working with personnel from like-minded embassies of other WTO members.

In Washington, an interagency team of experts coordinated by USTR, including principally the Departments of Commerce, State, Agriculture, Treasury, Labor, U.S. Patent and Trademark office, is working closely with personnel from the embassy and consulates.

Members of this team also interface regularly with U.S.-based trade associations and companies. Together with U.S. Government personnel in China, we are analyzing Chinese efforts at compliance and developing appropriate responses to problems.

Finally, let me say a few words about the Transitional Review Mechanism. Pursuant to the terms of China's accession agreement, an unprecedented multilateral review mechanism known as the Transitional Review Mechanism has been created. It calls for a detailed review of China's WTO compliance annually for the next 8 years, with a final review in year 10. It requires China to provide detailed information to WTO members for purposes of this review mechanism, and it gives WTO members the opportunity to raise questions about how China is complying with its commitments. Each year, the review will be conducted initially in 16 subsidiary WTO bodies, which includes 13 committees. Each committee will review implementation and report to the council overseeing it, which in turn will report to the WTO's General Council. The General Council will conduct its own review and make recommendations to China based on the results.

The last point—I see the yellow light—is on WTO dispute settlement. The normal WTO dispute settlement procedures apply fully between China and the U.S. The U.S. can invoke those procedures with regard to any of the particular commitments specified in China's agreements, as well as general obligations of China under the WTO.

The procedures governing a formal WTO dispute are set forth in the WTO's Understanding on Rules and Procedures Governing Settlement of Disputes. The so-called DSU provides for an initial 60-day period of consultations followed by additional time periods for making a request for the establishment of a dispute settlement panel and selecting the panelists. Although the ensuing briefing and hearing phases take place on an expedited basis, the panel normally would not be in a position to make a decision for several more months. If that decision is appealed, as is often the case, another 3 or 4 months go by before the appellate decision is rendered. As a result, the dispute settlement process will normally take about 18 months.

However, if there is a dispute over how the final decision is being implemented, further proceedings may be necessary after that.

As far as invoking this mechanism the Administration has not adopted a China-specific policy. Rather, it is applying the same standards and the same approach as it does for other WTO members.

The enormity of changes that China must make to comply with its commitments, both in terms of quality and substance, does set China apart. It will likely give rise to a greater number of problems than we normally experience with other WTO members, and for each of them, we will have to consider whether dispute settlements or some other response is advisable.

This is only one of the tools available to us. We continue to have our traditional bilateral means including use of U.S. trade laws, the TRM, and working with like-minded WTO members.

Thank you, Mr. Chairman. I look forward to answering your questions.

Co-Chairman MULLOY. Thank you, Mr. Ambassador. That was a very succinct, but very full statement.

[The statement follows:]

PREPARED STATEMENT OF JEFFREY BADER

I am pleased to appear before the U.S.-China Commission today to discuss the Administration's perspectives on the United States' trade relationship with the People's Republic of China. As the Chairman has requested, I will address four topics: (1) China's willingness and ability to comply with its WTO commitments; (2) the inter-agency process set up to monitor China's WTO compliance; (3) the WTO's so-called "Transitional Review Mechanism"; and (4) the mechanisms available to resolve trade problems with China, such as the WTO's dispute settlement procedures.

CHINA'S WILLINGNESS AND ABILITY TO COMPLY WITH ITS WTO COMMITMENTS

China's accession to the WTO was a decisive victory for reform in China. In recent years, China's reformers have clearly understood the values and benefits of openness in the economic sphere, and that is why they pursued WTO membership. They know that WTO membership will help them transform China's economy—and many hope and believe China's society generally—in positive ways.

This Administration, like the previous Administration, worked closely with China's reformers throughout the many years of WTO negotiations. Now that the negotiations are over, we want to continue to work with them in the next phase of this process, as China embarks on the enormous task of implementing the numerous WTO commitments it has made.

Clearly, implementation is and will be a major challenge for China and its reformers. They must find ways to ensure that recalcitrant ministries, State-owned enterprises and provincial and municipal authorities all act in conformity with China's WTO commitments.

But, China's leadership at least appears prepared to take on this challenge. It is committed to make China competitive in the international economic arena in the 21st century. It knows that it needs to develop a market economy compatible with the WTO's rules for this to happen. It also knows that there will be a price to be paid as this transition takes place.

The ability of China to meet this challenge and implement its WTO commitments in full will depend on the outcomes of several sets of dynamics.

One set of dynamics involves the central government's ministries. Some of them are reform-minded and generally understand the benefits of full compliance with WTO rules. The Ministry of Foreign Trade and Economic Cooperation (MOFTEC), which had the lead in the WTO negotiations, is one example. But, other ministries, particularly those with regulatory or proprietary functions or with a domestic focus, may be less interested in, indeed resistant to, full compliance. In certain circumstances, they will be more inclined to seek ways to protect their and their constituents' existing rights and privileges, and so they will present a particular challenge to the implementation process.

There will be a similar set of dynamics we will have to follow closely involving the central government and the localities. We can expect foot-dragging by some provincial and municipal authorities that do not see immediate benefits in complying with WTO rules, or that simply do not understand them. Historically, Beijing's influence has not extended uniformly over local authorities, and at this point the breadth and extent of this influence vis-à-vis China's WTO commitments remains unclear.

Realistically, we can expect some non-compliance as these internal struggles take place. Through all available and appropriate means, we intend to make clear what China's commitments are, and we will work closely with those institutions and elements in China that can help us to obtain compliance.

Before moving on to the next topic, let me add one further thought. It is also quite possible, if not probable, that, independent of these internal struggles, China will simply be unwilling to live up to a particular WTO commitment. As you know, we still have compliance problems with longstanding WTO trading partners, and there is no reason to expect that China will be different.

INTER-AGENCY MONITORING PROCESS

Given China's importance as a major trading power and the breadth and complexity of China's WTO commitments, the Administration has set up a comprehensive inter-agency monitoring effort to determine the extent to which China is complying with those commitments. USTR's China Office is coordinating this effort, which is being formally overseen by a newly created Trade Policy Staff Committee (TPSC) subcommittee (see 19 U.S.C. § 1872) whose mandate will be devoted exclusively to China and the extent to which it is complying with its WTO commitments.

All TPSC agencies have been invited to participate in this newly created subcommittee. The subcommittee held its inaugural meeting on December 4, 2001, at which it discussed organizational and tasking issues. We met yesterday for the second time. In the future, the subcommittee will meet on a monthly basis to evaluate and prioritize the monitoring activities being undertaken.

The monitoring activities are taking place on several fronts.

In China, State Department economic officers, Foreign Commercial Service officers, Foreign Agricultural Service officers and Customs attaches are very active, gathering and analyzing information, maintaining regular contacts with U.S. business and agricultural associations and companies doing business in China, maintaining a regular dialogue with Chinese government officials at key ministries and agencies, and working with personnel from like-minded Embassies of other WTO members.

In Washington, an inter-agency team of experts, coordinated by USTR and including principally the Departments of Commerce, State, Agriculture and Treasury and the U.S. Patent and Trademark Office, is working closely with personnel from the U.S. Embassy and Consulates General in China. Members of this team also interface regularly with U.S.-based trade associations and companies. Together with the U.S. government personnel in China, this team analyzes Chinese efforts at compliance and develops appropriate responses to systemic problems and potential WTO violations as they arise.

Finally, in Geneva, USTR and other agencies will be active participants in the WTO's annual Transitional Review Mechanism, which I will discuss next.

THE WTO'S TRANSITIONAL REVIEW MECHANISM

Pursuant to the terms of China's accession agreement, an unprecedented multilateral review mechanism known as the "Transitional Review Mechanism" has been created. It calls for a detailed review of China's WTO compliance annually for the next 8 years, with a final review in year 10. It requires China to provide detailed information to WTO members for purposes of this review mechanism, and it gives WTO members the opportunity to raise questions about how China is complying with its commitments.

Each year, the review will be conducted initially in 16 subsidiary WTO bodies, which include 13 Committees (the Committees on Balance-of-Payments Restrictions, Market Access, Agriculture, Sanitary and Phytosanitary Measures, Technical Barriers to Trade, Subsidies and Countervailing Measures, Anti-Dumping Measures, Customs Valuation, Rules of Origin, Import Licensing, Trade-Related Investment Measures, Safeguards and Trade in Financial Services) and three overseeing Councils (the Council for Trade in Goods, the Council for Trade-Related Aspects of Intellectual Property Rights and the Council for Trade in Services). Each Committee will review implementation matters within its mandate and then report the results of its review to the Council overseeing it. The Councils will consider these reports and also review additional implementation matters and then report to the WTO's General Council. Finally, the General Council will conduct its own review, and it then has the right to make recommendations to China based on the results of the reviews that have taken place.

The new TPSC subcommittee addressing China's WTO compliance will coordinate U.S. participation in the Transitional Review Mechanism. This subcommittee will work closely with existing TPSC subcommittees that focus on the regular work of the WTO bodies.

WTO DISPUTE SETTLEMENT PROCEDURES

The normal WTO dispute settlement procedures apply fully between China and the United States. The United States can invoke those procedures with regard to any of the particular commitments specified in China's accession agreement as well as with regard to the obligations that it is assuming by acceding to the many existing WTO agreements.

The procedures that govern a formal dispute at the WTO are set forth in the WTO's Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), although they may be modified by special rules contained in the particular WTO agreement governing the subject matter of the dispute. The DSU provides for an initial 60-day period for consultations, followed by additional time periods for making a request for the establishment of a dispute settlement panel and selecting the panelists. Although the ensuing briefing and hearing phases take place on a relatively expedited basis, the panel normally will not be in a position to issue its final decision for several more months. If the panel's decision is appealed to the WTO's Appellate Body, as often happens, another three or four months will go by before an appellate decision is issued. As a result, the dispute settlement process normally takes approximately 18 months. However, if there is a dispute over how the final decision is to be implemented, further panel proceedings may be necessary for the complainant to secure relief.

As far as invoking this dispute settlement mechanism goes, the Administration has not adopted a China-specific policy. Rather, it is applying the same policy that it has for other WTO members. The Administration will address each problem as it arises and apply the normal criteria for deciding whether dispute settlement is advisable at that time. Let me add, however, that the enormity of the changes that China must make to comply with its WTO commitments, both in terms of quantity and substance, does set China apart. It will likely give rise to a greater number of problems than we normally experience with our other WTO trading partners, and for each of them we will have to consider whether dispute settlement (or some other response) is advisable.

WTO dispute settlement, of course, is only one of the tools available to the United States to resolve trade problems with China. We will address problems through traditional bilateral means, including the use of U.S. trade laws. We will also use multilateral means other than dispute settlement. We will work with like-minded WTO members in Geneva and in capitals on an ad hoc basis to address problems with an adverse impact extending beyond the United States, and we will also actively use the WTO's Transitional Review Mechanism.

CONCLUSION

Mr. Chairman and members of the Commission, thank you for listening to me. I look forward to answering your questions.

Co-Chairman MULLOY. Secretary Lash?

STATEMENT OF WILLIAM H. LASH III, ASSISTANT SECRETARY OF COMMERCE FOR MARKET ACCESS AND COMPLIANCE, U.S. DEPARTMENT OF COMMERCE

Mr. LASH. Thank you, Mr. Chairman.

In your opening statement you addressed very eloquently the challenges we have in working with China toward WTO accession and, more importantly, WTO compliance. You stated that this is a two-way street—working with China to educate them on compliance matters and building a rule of law, as well as aggressively monitoring China-U.S. trade.

As you know, I am here representing the International Trade Administration of the Department of Commerce, and my division, Market Access and Compliance, or MAC, is charged with obtaining market access for U.S. firms and workers and to achieve full compliance by foreign nations with trade agreements they sign with our country. That is true with every country, and it is even more so with China.

China is our fourth-largest trading partner, and we are their largest export market. It provides very good opportunities but also very great challenges—opportunities and challenges for our workers, our companies, our ranchers and our farmers.

President Bush and Secretary Evans have made compliance a priority in our trade agenda. The results of the recent bipartisan Trade Deficit Review Commission—I know that many of the commissioners were also on that commission—similarly concurred that compliance with trade agreements must be a priority. No matter how many new trade agreements are drafted and signed by our negotiators, they are only paper, without quick and absolute monitoring and swift enforcement.

Last summer, I visited China for the first time, and like many people, I had preconceived notions of what I would find. In several cases, I think I was right, in some cases, I was wrong. As a lawyer, I will focus on where I was wrong first, and you might be more surprised.

Frankly, I expected to find a business community that was downhearted and distressed from finding a lack of opportunity. What I found was a generally optimistic environment. Businesses there, ranging from large-ticket items to airplanes to services, were all generally optimistic about the challenges and opportunities in the China market.

Similarly, when I met with our Chinese counterparts—I found an unprecedented eagerness to not just join the WTO but to be viewed as strong, willing, and responsible WTO players.

When I went to Shanghai, I had the opportunity to meet with the staff of the WTO Affairs Consultation Center. I walked in there planning to talk about my view of compliance. Their view of compliance, I found very much meshed with ours. I had an early warning system designed to monitor and track Chinese compliance with

WTO obligations, and they had one designed to match and monitor their own compliance.

The Shanghai Center has a plan to, within 5 years of accession, follow five priorities that they have outlined—(1) evaluating government plans; (2) setting up information networks, telling more people about WTO and WTO commitments; (3) establishing a research network; (4) creating a consulting network among government units, corporations, multiplier organizations, and various professional service providers; (5) providing WTO-related training programs; (6) holding annual conferences to review China's progress with WTO obligations; (7) evaluating results and establishing a professional services system.

The Center has something that it calls the 50/100 Training Program. They want to train 100 experts in each of the 50 units on WTO-related matters.

I have also brought with me copies of four different books available at the Center and, more importantly, at a newsstand at the airport in Shanghai. I have written several books on trade policy. I have never seen a book on WTO compliance in any American airport. I would love to boost my royalties. But frankly, it shows again that WTO has become something that they are as a population curious about and as a government very interested in.

I will also point out what we are doing at the Department of Commerce. We have a five-point—I hate to give more points again. The compliance plan for China, most of which comes, frankly, from the leadership and resources of you, Mr. Chairman, when you were head of MAC.

The key provisions of this program are, (1) to concentrate enforcement efforts; (2) to help China reform; (3) to promptly address market access problems; (4) to give U.S. companies a head start; and (5) to aggressively monitor trade flows.

First, when we talk about concentrating our enforcement efforts, again, our Department has put together a rapid-response China team consisting of five key offices throughout Commerce, allowing us to pull together experts on standards, on IT, on legal matters and treaties. We hold semi-weekly strategy sessions to review cases and implementation plans. We also have a new China-specific website, making more information available to our exporters.

Our China team representatives regularly meet with members of the Chinese Embassy here. Our commercial staff in Beijing regularly meet with Chinese Government officials to review specific market access and compliance problems.

Secondly, assisting China's reform efforts. We have been instituting numerous programs to assist Chinese officials on WTO-related matters of concern to U.S. companies. Our first team traveled to Beijing and Shanghai in the fall of 2000 to review China's future WTO obligations in areas like standards, IP protection, and antidumping requirements. In early 2001, half a dozen sessions were held in Washington, D.C. for Chinese officials on topics ranging from E-commerce regulation to corporate mergers and acquisitions to WTO to antitrust.

Also, we have been having a good dialogue with our Chinese counterparts by asking what is it that you need to know so that you can comply. Do you need help with standards; franchising law;

IP? Again, we have been taking our road show, if you will, not just to Beijing and Shanghai, but further to the provinces.

As I mentioned earlier, we are trying to promptly address our third point—market access problems. We set up our online hot-line for exporters to complain about possible challenges of violations in China.

But more importantly, our fourth point—giving our companies a head start—we spend a lot of time educating our own population on the ground in China as well as, obviously, here in the U.S., telling them of the opportunities in the Chinese market as well as what are their obligations, what market access, state-by-state, sector-by-sector, can U.S. companies and U.S. workers expect to get in China.

And fifth, aggressively monitoring trade flows. As you know, our Import Administration Office has been working with our commercial office in China to shorten the time frame for investigating dumping cases, CVD cases. People on the ground can do the investigations much more quickly and more efficiently and professionally than people flying from Washington to Beijing from time to time for investigations.

Our staff commitment has been outstanding. Given our new resources from Congress, we have more than doubled our China staff—I again have to thank Mr. Mulloy for getting those resources. We now have 14 full-time staff in the office in China, all of whom speak Chinese, which is obviously a great start. We have two people on the ground as commercial officers, working from my office with our exporters, telling them of the obligations of the Chinese Government and the opportunities, as well as, obviously, a very aggressive and large staff of our foreign commercial office in China.

I see the red light is on, so in conclusion, you have requested our comments on my assessment of China's willingness to comply. I cannot personally read the minds of 1.2 billion people——

Co-Chairman MULLOY. You can't?

Mr. LASH. —I am only one man, but with my staff, I'm sure we can get close to it—however, I do see a very serious intent by the Chinese leadership to comply. As the Chairman stated earlier, there may be problems and bumps in the road with various bureaucrats and various bureaucracies, who may not see the benefits of openness of trade. But obviously, I think China wants to be a good WTO partner because they have put their own economic and political procedures on the line within WTO compliance. We believe very firmly that promises made must be promises kept. We intend to work with China to help them comply with their own promises.

Again, thank you very much for your time; I would be glad to take any of your questions.

[The statement follows:]

PREPARED STATEMENT OF WILLIAM H. LASH III

Good morning. I thank you for the opportunity to discuss the Department of Commerce's vital role in enhancing U.S.-China relations by ensuring that China fully implements and complies with its WTO obligations, and that U.S. workers and farmers realize benefits from China's market opening concessions.

As you know, I am here today representing the International Trade Administration, and my division, Market Access and Compliance (or MAC). MAC's overriding objective is to "obtain market access for American firms and workers and to achieve full compliance by foreign nations with trade agreements they sign with our country." This year, our focus is to develop an enhanced interagency compliance strategy with additional efforts aimed at the textile sector; aggressively pursue compliance with trade agreements by China and Taiwan as new WTO members; and to greatly expand our program of actively addressing issues of concern in the compliance area raised by industry and by Members of Congress.

President Bush and Secretary Evans have made compliance a priority in our trade agenda. The results of the bipartisan Trade Deficit Review Commission similarly recognized the importance of compliance. No matter how many new agreements are signed and how encouraging the new conditions received by our negotiators, these commitments are only on paper without aggressive monitoring and swift enforcement. Because China is now our fourth largest trading partner and we are its largest export market, monitoring and enforcement of our agreements with China has become a priority.

When I was in China in August of last year, I spoke to U.S. businesses about the remarkable progress that they have already achieved in selling everything from telecommunications equipment to big ticket manufacturing items. And meeting with Chinese officials, I believe that many of them are serious about attracting investment by complying with their WTO commitments.

In Shanghai, I met with the leaders and staff of the WTO Affairs Consultation Center. As part of the Center's effort to demonstrate that Shanghai will implement its WTO obligations within five years of accession, eight priorities were outlined. These included: (1) evaluating government plans; (2) setting up an information network; (3) establishing a research network; (4) creating a consulting network among government units, corporations, multiplier organization and various professional service providers; (5) providing WTO-related training programs; (6) holding an annual conference to review progress; (7) evaluating results; and (8) establishing a professional services system. The center has something it calls the 50/100 Training Program—that is to train 100 experts in each of 50 units on WTO related matters.

The goal of the program is to produce practitioners who understand the multilateral trading system and have mastered WTO rules, understand the WTO dispute settlement processes, and have learned to speak at least one of the WTO official languages. In order to realize the three-part program plan (basic introduction, intensive studies and overseas training), the Center will need significant support, especially in developing course materials and case studies for this training and in identifying appropriate hosts for their participants during the overseas training phase (a six-month period), so it is working closely with the U.S. Consulate General in Shanghai to identify equipment and human resources needs to accomplish Center goals. The Center demonstrates that China knows that WTO compliance is important and that it will not come without commitment. Our Consulate in Shanghai, working closely with the business community and other USG agencies, has carried out a wide range of technical assistance and capacity building programs with the Shanghai WTO Center.

I have also brought with me today four books published by the Chinese government on WTO commitments and new requirements that are being sent out to regional and local officials. These and other forms of technical assistance and education are already bearing fruit by enhancing transparency beyond China's WTO obligations. One example of progress comes from an agency I met with: the State Development Planning Commission (SDPC). The SDPC now requires public comments to be solicited on price changes on services which are "essential to daily life," and the SCPC just last weekend held a hearing on holiday rail rates. These examples and many others suggest an interest and willingness to open markets and increase transparency, but as you are surely aware, China's record on these matters is mixed.

To address the many layers of coordination that allow for compliance, the WTO accession process is intended to probe and to engage non-transparent and protectionist systems to bring them up to global standards. Earlier this year, Mr. Gary Benanev of New York Life Insurance Company testified in front of this commission that China lacks the institutional structure and enforcement mechanisms necessary for the Chinese market to be accessible to foreign competition and to support domestic industries. He also noted that "the more China is rooted in the international rules-based trading system the greater the cost to China's own economy of taking political or military steps that undermine this system." We all hope that this prognosis proves true and that WTO accession provides U.S. workers and businesses with not only greater access to the Chinese market but also an improved Chinese business environment that will embrace free and fair trade.

FIVE-POINT COMPLIANCE PLAN FOR CHINA

In response to the extensive concern about Chinese compliance, the Department has constructed a five-point Compliance Plan for China. The key provisions of the plan are to: (1) concentrate enforcement efforts; (2) help China reform; (3) promptly address market access problems; (4) give U.S. companies a head start; and (5) aggressively monitor trade flows. We developed this plan as China's accession to the WTO accession procedure moved forward. It is now in place and we stand ready to implement the plan for all the provisions to which China agreed.

1. Concentrated Enforcement Efforts and Interagency Coordination

First, we will concentrate our enforcement efforts. The Department has established a rapid response China Team, consisting of five key offices throughout Commerce, allowing us to pull expertise from these divisions. The Team holds semiweekly strategy sessions to review cases and implementation plans and works closely with the interagency China WTO Implementation group to discuss future interagency efforts. A new China-specific website (www.export.gov/china) provides U.S. business with detailed information on China's WTO obligations, compliance, and market opportunities. China Team representatives regularly meet with Chinese Embassy officials here in Washington, and our Commercial Service officers in Beijing regularly meet with Chinese government officials to review specific market access and compliance problems.

The Commerce Department has a strong record in solving compliance problems across the globe in just this way—nipping them in the bud, before they grow into serious trade disputes. Our China Office works very closely with the Trade Compliance Center, one of the divisions of my own MAC unit. The TCC gets compliance complaints from a wide variety of sources—U.S. companies e-mail us, they write or fax us, or they find our website and submit an on-line complaint. But also, we actively go to them seeking their input—we conduct outreach efforts to seek out any problems that may be brewing. And last year Secretary Evans invited each Member of Congress to designate one staff member to work with our Trade Compliance Center to refer constituent market access and compliance problems.

The TCC reviews every one of these trade complaints, and develops action plans to resolve them. The TCC puts together a team of experts, including country desk, industry, functional, and legal experts, who work to solve these cases.

To strengthen the force of our efforts, Commerce works hand-in-hand with other agencies to focus efforts. Last month, a new interagency China WTO Compliance committee held its inaugural meeting. Chaired by the U.S. Trade Representative (USTR), the interagency group will meet monthly, and its mandate is to coordinate the U.S. government's efforts to ensure that China complies with its WTO commitments.

Our interagency plan includes a number of components. The first is coordinated and focused information gathering and monitoring by officials from the State Department, Commerce Department, Agriculture Department, and the U.S. Customs Service in Washington, our Embassy in Beijing, consulates in Shanghai, Guangzhou, Shenyang, Chengdu and Hong Kong, and the U.S. Mission in Geneva. We will also, on an interagency basis, maintain regular dialogues with other WTO members, engage in outreach to U.S. business about their new opportunities and rights, provide the Chinese with technical assistance, participate in the WTO's Transitional Review Mechanism Process, help facilitate Congressional oversight, and enforce U.S. rights through the WTO dispute settlement process where appropriate.

2. Assisting in China's Reform Efforts

The Department also intends to help in China's reform efforts. The whole of the U.S. government involved in China policy, and the Commerce Department in particular, know how important technical assistance programs are in creating market opportunities for U.S. companies. And with China's accession to the WTO, U.S. technical assistance programs put us in a position both to help the Chinese comply with their WTO obligations as well as increase U.S. market share in China in relation to third countries.

We have already initiated a series of training programs for Chinese officials on WTO-related issues of concern to U.S. business. Our first team traveled to Beijing and Shanghai in the fall of 2000 to review China's future WTO obligations in areas like standards, intellectual property rights and anti-dumping requirements with Chinese officials and the resident U.S. business community. In early 2001, a half-dozen sessions were held in Washington for Chinese officials, on topics ranging from e-commerce regulation to corporate mergers and acquisitions, to WTO anti-dumping rules.

Subsequently, China Team officers traveled to China with the American National Standards Institute for seminars in Beijing and Xian, organized Intellectual Property Rights Enforcement Training sessions in Shenyang, Hangzhou, and Xiamen, and conducted information technology and semiconductor seminars in Beijing. A Medical Equipment Standards program was held jointly with the EU in Kunming, China in August.

Now that China has officially joined the WTO, our China Office is preparing a series of up to half-a-dozen technical assistance programs in Fiscal Year 2002, including training in sector-specific areas, as well as more general rule of law issues, including a program on the Rule of Law for Distribution and Franchising in Beijing and Guangzhou. We are also exploring the possibility of posting a website in Beijing for Chinese officials and U.S. businesses, which will provide WTO implementation and compliance guidance.

3. Promptly Addressing Market Access Problems

The third element is promptly addressing market access problems. Solving commercial problems, before they escalate to the formal application of U.S. trade law or use of the WTO dispute settlement process, is in the interest of everyone—U.S. companies, and both the U.S. and Chinese governments. To this end, MAC and the U.S. and Foreign Commercial Service developed a guide for U.S. companies on "Dispute Avoidance and Dispute Resolution in China," and recently, Commerce staff reviewed the arbitration process in China and will make recommendations for improvements at the next U.S.-China Joint Commission on Commerce and Trade (JCCT) meeting.

4. Give U.S. Companies a Head Start

Fourth in our five-point plan, is to give U.S. companies a head start. In the Fall of 2001, Commerce held a dozen seminars for business people on the expected changes in the Chinese market after the Doha Ministerial and on the type of compliance support that we are able to provide. We want U.S. companies to be aware of their opportunities and rights in China. In addition to this general information, the Department also is sponsoring video conferences to connect businesses with the Commerce Staff in China, allowing for interactions with presenters and quick feedback.

Our staff are also on the look out for opportunities to focus our efforts on small and medium sized enterprises (SME's) because every aspect of an opaque or unwelcoming business environment poses a large barrier for smaller firms. One example was when our team in August 2000 organized a virtual trade mission to China's Computerworld Expo for fifteen SME's to present their products. Giving U.S. companies a head start is also going to lead us to catalogue and coordinate sales opportunities for 2008 Beijing Olympics and provide more sector reports and outreach to tailor our efforts to industry needs.

5. Aggressively Monitor Trade Flow

Finally, after four points to push exporters forward, MAC and the rest of the Department will aggressively monitor trade flows to ensure that imports do not catch us off guard. We have a China-specific antidumping and circumvention program to closely watch and directly address any market-altering changes as soon as they occur, as well as a subsidies group that will monitor China's provision of financial assistance and state aids to industrial enterprises to ensure that they conform with WTO commitments.

These five points are focusing our China experts to achieve the most complete results possible, but the Secretary himself is also keenly interested and involved in pushing for U.S. business when the lower channels do not open. The U.S. China Joint Commission on Commerce and Trade (or JCCT) is a cabinet-led commercial forum, which the Secretary chairs with his counterpart at China's Ministry of Foreign Trade and Economic Cooperation. The JCCT contains three ongoing working groups covering trade and investment issues, business development and industrial cooperation, and commercial law, with a side dialogue on export controls. The JCCT is planning to meet this Spring at the Secretarial level, and MAC will be able to raise its review of China's arbitration process and many other issues at the highest level. In addition to JCCT, the Secretary was represented by Deputy Secretary Bodman at the Asia Pacific Economic Conference where he met with several Chinese ministers and officials to address key issues.

Finally, an additional mechanism for ensuring Chinese compliance with its WTO commitments is the WTO's Transitional Review Mechanism (TRM). China's WTO accession agreement created this unprecedented new mechanism for reviewing China's compliance with its WTO commitments. The TRM takes place annually for the next eight years, with a final review in year ten. The TRM requires China to provide detailed information to the WTO membership, and it gives all WTO members the opportunity to raise questions about Chinese compliance with its WTO commitments.

STAFF COMMITMENTS

Of course, the most important piece in making this plan work is staff, and fortunately for me, there are several levels of Commerce staff with industry and country expertise to attack problems head on. In addition to my Washington team who monitor agreements and work the problems from this end, the Foreign Commercial Service has seventeen officers in five offices in China: in Beijing, Shanghai, Guangzhou, Chengdu, and Shenyang. Working with those officers, there are approximately 70 foreign service nationals (FSN's) and Personal Service Contact (PSC) employees to assist our businesses. In 2000, our commercial staff in China counseled 3,558 firms, including 1,210 newcomers to the Chinese market (and 602 first-time exporters); hosted 56 trade missions; provided 63 Gold Key Services, arranging for U.S. company representatives to have several face-to-face meetings with different potential business partners; and submitted 28 industry sector analyses describing business conditions and opportunities in the most promising export areas. In addition, Congress has appropriated funds to establish four new commercial service positions in China to assist with the compliance effort. Our China staffs seek out specific opportunities for businesses looking to move into China, but they are also critical in our constant vigilance of possible market access and compliance problems.

CONCLUSION

In your invitation to me, you requested my assessment of China's willingness and ability to comply with its WTO commitments. I personally believe that the leadership of China is earnest in its commitments to play by the rules of the WTO system, even with the enormous structural challenges that WTO membership entails domestically. But it's not my job to assess a country's willingness to play by the rules. Rather, it's my job to ensure that other countries comply with our trade agreements. And the compliance plan which I outlined above will ensure that U.S. businesses will find significant new opportunities in the China market.

The Secretary has tasked the Department to bolster U.S. business as we lead forcefully in opening markets around the world to free and fair competition. We are keenly aware of our complicated responsibilities in the delicate balance of international cooperation in military, diplomatic and economic spheres.

National security, you have been told, will be enhanced by engagement both politically and economically. American corporate presence builds stronger labor standards and wages, opens access to information, raises the standard of living, and encourages global focus in a nation that has been historically isolated. American investment means that American companies put financial, technical, and physical capabilities in China, and China will become more democratic with newly independent workers and ideas.

As these efforts move forward, Commerce will be focused on American companies and American workers to ensure that China is living up to her new and integrated world position.

I thank you again for your time and I would be happy to take questions.

Co-Chairman MULLOY. Thank you, Mr. Secretary, both for your statement and your kind remarks.

Next, we will hear from Mr. Shaun Donnelly from the State Department, who is Acting Assistant Secretary for Economics and Business.

STATEMENT OF SHAUN DONNELLY, ACTING ASSISTANT SECRETARY, BUREAU OF ECONOMIC AND BUSINESS AFFAIRS, U.S. DEPARTMENT OF STATE

Mr. DONNELLY. That is correct. Both Undersecretary Larson and Assistant Secretary Wayne are traveling right now, so I am representing State.

Thank you, Mr. Chairman, for inviting me. I appreciate the opportunity to provide the State Department perspective on issues surrounding China's WTO compliance.

The State Department, along with the entire U.S. Government, warmly welcomed the recent accessions to the WTO of the People's Republic of China and Taiwan. The agreement to admit the People's Republic of China was the culmination of a 15-year process of negotiations between China and other WTO members and 23 years of economic reform in China. It was a landmark agreement that holds significant benefits for U.S. national interests as well as those of China and the world community.

In terms of U.S. economic interests, the measures that China has agreed to will create long-awaited opportunities for U.S. exporters and investors in the world's fifth-largest trading entity. By entering the WTO, China has agreed to make one-way concessions to open its markets and bind itself to a rules-based, market-oriented trading system.

I will not go into detail on the package itself, but I want to underscore its expected results—more export and investment opportunities for U.S. companies and ultimately, more jobs for American farmers and workers.

I want to highlight the positive impact that changes inherent in WTO membership will have on the Chinese economy and society. China's commitments to provide transparency and improve its rule of law will not only benefit foreign companies but also the Chinese private sector. This is the most vibrant part of the Chinese economy, but one that has often felt disadvantaged in relation to the state-owned companies. A stronger private sector in China means more job creation, higher incomes, and a larger market for U.S. exports, and it means that the influence of state-owned companies on the economy and society will decline over time.

Of course, U.S. objectives in our relationship with China go beyond economic interests, and we believe that China's accession to the WTO also advances U.S. interests in other critical areas, including strengthening of rule of law and civil society and giving China a greater stake in enhancing regional and global stability.

China has agreed to implement measures that will open, liberalize, and make more transparent and predictable its economy and its administration. It is required to make broad reforms in transparency, provide for notice and comment, and apply laws and judicial review uniformly.

Because of China's adoption of more transparent rulemaking procedures, ordinary Chinese citizens should become more aware of their legal rights and will be able to participate in making the rules.

In addition, China's WTO accession integrates it more firmly into the Pacific and world economies and gives China a greater stake in regional and global stability. This in turn enhances prospects for peace and prosperity in the Asia-Pacific region, a critical area of U.S. interest.

The Department of State, along with the entire U.S. Government, attaches great importance to timely and effective implementation by China of its WTO agreements. Based on our discussions with China's senior political leadership, we are confident that it too takes very seriously its commitments and is working hard to implement them.

That said, it is important to underscore the broad scope, complexity, and depth of changes that the Government of China must enact to meet these obligations. It must create or revise and enforce scores of laws and regulations in areas affecting everything from intellectual property rights to foreign investment to administrative procedures across the entire economy.

For example, it issued over 20 important new trade-related laws and regulations in the 2-week period following accession. Thus, it will require a massive effort for China to comply with all the commitments it has undertaken as part of its WTO accession in a timely and thorough manner and for the United States to monitor and seek compliance with these commitments.

There will likely be bumps in the road to implementation for the Chinese Government. Government officials may have difficulty meeting deadlines for certain measures. Local officials initially may not be able to fully grasp the depth of changes needed. There may be pockets of resistance within China to full implementation of painful changes in areas like agricultural liberalization or IPR. Therefore, it is imperative that we remain vigilant and engaged to protect U.S. interests.

Recognizing this, the U.S. Government has worked diligently to establish a system for promoting maximum compliance. As we have heard, there is a comprehensive interagency effort to do this under the TPSC Subcommittee on China WTO compliance, and the State Department is a full and active participant in that effort.

My colleagues at USTR and Commerce will address in more detail the broader U.S. monitoring efforts. I would just like to say a few words about the State Department's role in encouraging China to fully implement its commitments.

We obviously play a central role in coordinating our overall China policy, and we will ensure that WTO implementation remains a high priority in our overall bilateral discussions with Chinese Government representatives.

Our Embassy in Beijing and our consulates throughout China and Hong Kong are playing a critical role on the front lines in the WTO compliance effort. Ambassador Randt has made China WTO implementation one of his top priorities for his mission.

In Beijing, the Embassy has established a WTO Implementation Coordination Committee chaired by the Embassy Economic Minister to coordinate the efforts of officers of the Departments of State, Commerce and Agriculture and Customs attaches. They are responsible for tracking and analyzing the changes in these laws, maintaining regular dialogue with government officials and undertaking outreach efforts and other tasks.

The Embassy has also formed a special IPR working group to monitor China's WTO intellectual property legislation and enforcement. Our consulates in Shanghai, Guangzhou, Chengdu, Shenyang, and Hong Kong, are also key players in WTO compliance efforts.

Our consulate in Shanghai has worked with the U.S.-China Business Council on a 10-part digital video conference series on The Implications of China's WTO Accession.

The Embassy's Economic Section in Beijing has worked with the Chinese Government on a training course on WTO compliance. And our public affairs staff in China and Hong Kong is doing some innovative capacity-building programs.

We are very busy on this. It is a very important effort, and the State Department will be a major player as we move forward in this important effort to advance American interests.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF SHAUN DONNELLY

Thank you for inviting me today. I appreciate the opportunity to provide the State Department perspective on issues surrounding China's WTO compliance.

Overview

The State Department, along with the entire U.S. Government, warmly welcomed the recent accessions to the World Trade Organization of the People's Republic of China and Taiwan. The agreement to admit the People's Republic of China was the culmination of a 15-year process of negotiations between China and other WTO members and 23 years of economic reform in China. It was a landmark agreement that holds significant benefits for U.S. national interests, as well as those of China and the world community.

In terms of U.S. economic interests, the measures that China has agreed to will create long-awaited opportunities for U.S. exporters and investors in the world's fifth largest trading entity. By entering the WTO, China has agreed to make one-way concessions to open its markets and bind itself to a rules-based, market-oriented trading system. To become eligible for WTO membership, China had to negotiate bilaterally with WTO members on increased market access for industrial goods, agricultural products, and services and on improved protection for intellectual property rights. China also negotiated a multilateral accession package detailing how it would meet fundamental WTO principles and obligations. While I won't go into detail on the package itself, I want to underscore the expected results of it: more export and investment opportunities for U.S. companies and ultimately more jobs for Americans farmers and workers.

I also want to highlight the positive impact that changes inherent in WTO membership will have on the Chinese economy and society. China's commitments to provide transparency and improve its rule of law will not only benefit foreign companies but also the Chinese private sector. This is the most vibrant part of China's economy but one that has often felt disadvantaged in relation to the state-owned companies. A stronger private sector in China means more job creation, higher incomes and a larger market for U.S. exports. And it means that the influence of state-owned companies on the economy and society will decline.

Of course, U.S. objectives in our relationship with China go beyond economic interests, and we believe China's accession to the WTO also advances U.S. interests in other critical areas, including strengthening of rule of law and civil society and giving China a greater stake in enhancing regional and global stability.

China has agreed to implement measures that will open, liberalize and make more transparent and predictable its economy and administration. It is required to make broad reforms in transparency, provide for notice and comment, and apply laws and judicial review uniformly. Because of China's adoption of more transparent rulemaking procedures, ordinary Chinese citizens will become more aware of their legal rights and will be able to participate in making the rules. Taking advantage of this change, Chinese securities companies, as well as their foreign counterparts, recently submitted comments on securities laws. Thus, enhanced transparency and predictability, while helping U.S. business, also contribute to promoting rule of law, the growth of civil society, and enhanced personal freedoms—goals central to our broader China policy.

In addition, China's WTO accession integrates it more firmly into the Pacific and world economies and gives China a greater stake in regional and global stability. This, in turn, enhances prospects for peace and prosperity in the Asia-Pacific region, a critical area for U.S. interests. We are also hopeful that China's further integration into the international system will contribute to more constructive and cooperative bilateral relations with the United States and other international players.

Views on China's Implementation of its WTO Commitments

The Department of State, along with the entire U.S. Government, attaches great importance to timely and effective implementation by China of its WTO agreements. Based on our discussions with China's senior political leadership, we are confident that it too takes very seriously its commitments and is working hard to implement them.

That said, it is important to underscore the broad scope, complexity, and depth of changes that the Government of China must enact to meet these obligations. It must create or revise and enforce scores of laws and regulations in areas affecting everything from intellectual property rights to foreign investment to administrative procedures across the entire economy. For example, it issued over 20 important new trade-related laws and regulations in the two-week period following accession. In addition, it must train officials at all levels of the government and state-owned enterprises to alter their behavior, a huge undertaking to which it has begun devoting a tremendous effort. Thus, it will require a massive effort for China to comply with all the commitments it has undertaken as part of its WTO accession in a timely and thorough manner and for the United States to monitor and seek compliance with these commitments.

There will likely be bumps in the road to implementation for the Chinese Government. Government officials may have difficulty meeting deadlines for certain measures. Local officials initially may not be able to fully grasp the depth of changes needed. There may be pockets of resistance within China to full implementation of painful changes in areas like agricultural liberalization or intellectual property protection. Therefore, it is imperative that we remain vigilant and engaged to protect U.S. interests.

Recognizing this, the U.S. Government has worked diligently to establish a system for promoting maximum compliance. This involves a comprehensive interagency organization for monitoring China's compliance in Washington, China, and Geneva. At the center of our efforts is a newly-created interagency Trade Policy Staff Committee (TPSC) Subcommittee on China WTO Compliance. This committee, chaired by the Office of the U.S. Trade Representative and including representatives from the Departments of State, Commerce, Agriculture, and Treasury and many other agencies, is meeting on a monthly basis, with additional subgroup meetings. Our Missions in China and Geneva will also play critical roles not only in monitoring but also in pressing China to fulfill all of its commitments. At all levels and locations, we will diligently seek to hold China to its obligations. The WTO itself provides access to new multilateral tools such as the Transitional Review Mechanism and dispute settlement, in addition to bilateral efforts, to resolve trade problems.

The Contribution of the Department of State

While my colleagues in USTR and Commerce will address in more detail broader U.S. Government monitoring efforts, I would like to focus on the State Department's role in encouraging China to fully implement its commitments. As you know, the State Department plays a central role in coordinating our overall China policy and will ensure that WTO implementation remains a high priority in our bilateral discussions with representatives of the Chinese Government. State Department principals and staff will also continue to reach out to the U.S. business community and other constituencies to hear their concerns, coordinate with other diplomatic missions, and be active participants in the TPSC subcommittee and other interagency discussions.

Our Embassy in Beijing and our Consulates throughout China and Hong Kong are also playing a critical role on the front lines in the WTO compliance effort. Ambassador Randt has made China WTO implementation one of the top priorities for his Mission. In Beijing, the Embassy has established a WTO Implementation Coordination Committee chaired by the Economic Minister to coordinate WTO monitoring, compliance, technical assistance, and outreach efforts of State Department Economic, Environment, Science and Technology and Public Affairs officers, as well as Foreign Commercial Service officers, Foreign Agricultural Service officers and Customs attaches. This group is responsible for tracking and analyzing changes in laws and regulations, maintaining regular dialogue with government officials on WTO commitments, undertaking outreach programs for Chinese government and other audiences, and meeting regularly with members of the private sector and other diplomatic missions to assess progress and identify possible problems. The Embassy has also formed a special IPR working group to monitor China's WTO intellectual property legislation and enforcement and to conduct outreach.

Our consulates in Shanghai, Guangzhou, Chengdu, Shenyang and Hong Kong are also key players in WTO compliance efforts. The outstanding information-gathering and advocacy work done by these Consulates is critical to our efforts because China's greatest implementation challenge will be at the local and regional levels.

To prepare itself for the important responsibility of WTO compliance, the Mission is enhancing training of personnel from the Embassy and Consulates, including holding in-country training programs in conjunction with the National Foreign Affairs Training Center and Office of the U.S. Trade Representative.

I want to underscore how proud we are of our State Department officers in China and Hong Kong. Working in posts that are already extremely busy, they have taken on enormous new responsibilities and are doing an outstanding job. Let me share with you a couple of examples of the work being done by State Department staff in China.

—Consulate Shanghai, in cooperation with the U.S.-China Business Council, has organized a 10-part digital video conference (DVC) series on the Implications of China's WTO Accession. This facilitates dialogue between U.S. experts and a group of one hundred officials and state-owned enterprise managers in Shanghai selected to become WTO experts and policy advisors for their respective agencies.

—The Embassy's Economic Section in Beijing designed and co-hosted with the Chinese Government a well-received course that explained WTO compliance issues to Chinese government officials and academics. It is also developing a Chinese-language online course to teach basic WTO principles. Once the course content is finished, a U.S. company has agreed to support its maintenance.

—Finally, I want to highlight the innovative WTO capacity-building programs being conducted by our public affairs staff throughout China and Hong Kong. These include furnishing books for a law library for the Chinese government legal department charged with interpreting China's WTO commitments, translating materials recommended by the WTO Secretariat training office, constructing an improved website, ensuring maximum public outreach for visiting Washington officials, effectively using international and voluntary visitor programs, and making small grants to seed capacity-building programs.

State Department staff at our Mission in Geneva are also actively involved in China WTO compliance efforts, and we will call on staff in other Embassies abroad as needed.

Impact on Other Priorities in Our Relationship

As I mentioned up front, we believe China's WTO membership will contribute to and complement the achievement of other U.S. priority objectives in our relationship with China and internationally. In the economic area, the President and Secretary were very pleased by their visits to Shanghai last October to take part in APEC meetings and look forward to working with China to strengthen this organization's work on liberalizing trade and promoting enhanced cooperation in the region. We believe APEC provides a useful forum to encourage further liberalization by China.

While we realize that in the short term China will be focused on changing its own policies to meet its WTO obligations, we are also hopeful that it will play a positive role within the WTO in the next round of WTO negotiations launched at Doha in November. Issues like further liberalizing agricultural trade and services will be difficult in this upcoming round, and China's support will be helpful. For example, the U.S. and Chinese governments share an interest in limiting agricultural subsidies and may be able to cooperate in this area. Hopefully, the critical role of trade liberalization in China's recent economic success will not be lost on other developing countries. As the first meeting of the WTO New Round Trade Negotiation Committee (TNC), scheduled for January 28, approaches, we should begin to see signs of China's New Round strategy, and how it will wield influence with other WTO Members.

Finally, given the importance of agricultural biotechnology to our economy and to international food security, we look to engage the Chinese in a constructive dialogue on a science-based, rules-based approach to agricultural biotechnology products.

In conclusion, I want to reiterate the President's call for a relationship with China that is candid, constructive, and cooperative. We will not hesitate to address directly our differences, including those related to trade, and we will seek to build on our common interests. While we have a lot of hard work ahead, we believe that China's accession to the WTO will be good for U.S. interests, for U.S. business, for U.S. workers, farmers and consumers and for U.S. broad national interest. Thank you.

Co-Chairman MULLOY. Thank you, Mr. Secretary.

I just want to note—you mentioned the Ambassador and the priority he puts on this—the Ambassador met with us before he went out, and when we went out as a Commission, he received us and spent some time with us with his team. And it is very clear that this is a key interest.

Mr. DONNELLY. Yes. This is absolutely at the top of his list; I can certainly attest to that.

Co-Chairman MULLOY. Next, Ms. Sheikh, from the Department of Agriculture.

STATEMENT OF PATRICIA R. SHEIKH, DEPUTY ADMINISTRATOR, INTERNATIONAL TRADE POLICY, FOREIGN AGRICULTURAL SERVICE, U.S. DEPARTMENT OF AGRICULTURE

Ms. SHEIKH. Thank you, Mr. Chairman, members of the Commission, for the opportunity to discuss the significant impact of China's entry into the World Trade Organization on U.S. agriculture and how the United States will effectively monitor China's WTO compliance.

The integration of China into the global trade community offers timely benefits for U.S. agricultural producers, processors, and exporters. With 1.3 billion people—one-fifth of the world's population—China's accession to the WTO gives United States agriculture access to one of the world's largest and fastest-growing economies.

New export opportunities will emerge for a broad range of U.S. agricultural products, including grains, meats, produces, cotton, and processed goods.

China's accession to the WTO dramatically cut import barriers currently imposed on U.S. agricultural products. When fully implemented, USDA estimates that by 2005, China's WTO commitments could add approximately $2 billion a year to U.S. agricultural exports due to tariff reductions.

Under the 1999 U.S.-China bilateral access agreement, China agreed to cut tariffs by more than half on priority U.S. agricultural products such as beef, poultry, cheese, oranges, apples, wine, and grapes—and this is just to name a few.

With WTO entry, China also agreed to end its system of discriminatory licensing and import bans for bulk commodities and to create market access opportunities by establishing a WTO-consistent tariff-rate quota system. China established larger and increasing TRQs for their state-trade commodities such as wheat, corn, cotton, rice, and soybean oil. China has also committed to low, within-quote tariffs of 1 to 3 percent for imports of bulk commodities, which will help American farmers take full advantage of the TRQs.

In addition, China committed to allow a share of the TRQs for each commodity to be imported by entities other than state trading enterprises and agreed to specific rules for the administration of these so-called TRQs.

The introduction of private trade for these commodities combined with increased transparency in the process will ensure increased opportunities for American agricultural exports. China committed not to use export subsidies for agricultural products when it joined the WTO. This commitment will level the playing field in third-country markets for U.S. exports of corn, rice, and cotton, which in the past have been displaced by unfairly traded Chinese exports.

On domestic support, China committed to cap any trade-distorting domestic support at 8.5 percent of its total value of agricultural production. China's subsidies to its agricultural production are currently very low. In addition, China has also committed to provide greater transparency to make its domestic support measures more predictable.

China has committed to fully abide by the terms of the WTO Agreement on Sanitary and Phytosanitary Measures, which requires that all animal, plant, and human health import requirements be based on sound science—not political agendas or protectionist concerns. Additionally, China and the United States agreed bilaterally on the terms for the removal of unscientifically unjustified phytosanitary and sanitary restrictions on imports of U.S. wheat and other grains, citrus, and meat.

The China WTO accession agreement explicitly permits the U.S. to continue to use its non-market anti-dumping methodology for 15 years after China's accession to the WTO. China has also committed to a strong product-specific safeguard that allows the United States for 12 years after accession to restrain increasing imports from China that cause or threaten market disruption in the United States. After that, current U.S. safeguard provisions—that is, Section 201—will remain available to address increasing imports should that ever happen.

American farmers will benefit from expanded trading rights. Currently, only companies that receive specific authorization from the Chinese Government are allowed to import into China. Under the agreements, China has committed to allow any entity to import most products into any part of the country within 3 years of accession. A select list of products will be partially exempt from this rule, and some trade will be channeled through China's state-trading enterprises.

However, specific commitments to end monopoly import status have also been established. Additionally, China has committed to liberalize distribution services for all agricultural products except tobacco, allowing U.S. companies to distribute and market their products in China.

In short, American farmers will benefit from dramatically expanded market access opportunities. American farmers will realize enormous benefits in virtually every agricultural sector.

With China's membership in WTO, under the protocol of accession we helped to negotiate, China agreed to undertake numerous trade-liberalizing commitments which will improve market access for U.S. agriculture. We recognize that WTO implementation will present a major challenge, both for China and its trading partners. China will need to revamp its system, to rewrite and amend thousands of laws, rules, and regulations at the central and provincial levels. The United States Department of Agriculture stands ready to help China do that.

We understand that this promises to be a long process given the complexity of the Chinese economy and import system. The effort to effectively monitor and enforce China's WTO commitments is taken seriously by the U.S. Department of Agriculture.

In addition to the ongoing interagency process that was described by Ambassador Bader and the U.S. Department of Commerce, USDA is in the process of establishing a China Task Force to monitor China's compliance with its WTO commitments. The team will draw from expertise across the U.S. Department of Agriculture. The team will also draw from the work of our overseas posts—and you heard the State Department report on how they are involved in the process—industry groups, and of course, we will coordinate very closely with our sister agencies, USTR, and to the extent we need to with the Department of Commerce.

We are currently planning consultations with China on their new biotechnology regulations to ensure that new regulations do not stop trade. USDA considers this issue a high priority, given the importance of the Chinese market to U.S. agricultural producers.

In conclusion, we strongly believe that the entry of China into the rules-based system of the WTO benefits U.S. farmers and ranchers, exporters, manufacturers, and food processors. U.S. agriculture now has access to China's 1.3 billion consumers. To realize the potential benefits provided by China's WTO membership, USDA intends to aggressively monitor and enforce China's WTO commitments.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF PATRICIA R. SHEIKH

Mr. Chairman, members of the Commission, thank you for the opportunity to discuss the significant impact of China's entry into the World Trade Organization (WTO) on U.S. agriculture and how the United States will effectively monitor China's WTO compliance.

On December 11, 2001, China became the 143rd member of the World Trade Organization (WTO) marking the culmination of protracted negotiations during the past 15 years. The integration of China into the global trade community offers timely benefits for U.S. agricultural producers, processors, and exporters. With 1.3 billion people, one-fifth of the world's population, China's accession to the WTO gives U.S. agriculture access to one of the world's largest and fastest growing economies. New export opportunities will emerge for a broad range of U.S. agricultural products, including grains, meats, produce, cotton, and processed goods.

China's accession to the WTO dramatically cut import barriers currently imposed on American agricultural products. When fully implemented, China's WTO commitments could add approximately $2 billion a year to U.S. agricultural exports due to tariff reductions. Under the 1999 U.S.-China bilateral access agreement, China agreed to cut tariffs by more than half on priority U.S. agricultural products such as beef (from 40% to 12%), poultry (from 20% to 10%), cheese (from 50% to 12%), oranges (from 40% to 12%), apples (from 30% to 10%), wine (from 65% to 20%), grapes (from 40% to 13%), to name a few.

With WTO entry, China also agreed to end its system of discriminatory licensing and import bans for bulk commodities, and to create market access opportunities by establishing a WTO-consistent tariff-rate quota (TRQ) system. China established larger and increasing TRQs for their state-traded commodities such as wheat, corn, cotton, rice and soybean oil. China has also committed to low, within-quota tariffs of 1–3 percent for imports of bulk commodities which will help American farmers take full advantage of the TRQs. In addition, China committed to allow a share of the TRQs for each commodity to be imported by entities other than state-trading entities and agreed to specific rules for the administration of these TRQs. The introduction of private trade for these commodities—combined with increased transparency in the process—will ensure increased opportunities for American agricultural exports.

China committed not to use export subsidies for agricultural products when it joined the WTO. This commitment will level the playing field in third-country markets for U.S. exports of corn, rice, and cotton—which in the past have been displaced by unfairly traded Chinese exports.

On domestic support, China committed to cap any trade-distorting domestic support at 8.5 percent of its total value of agricultural production. China's subsidies to its agricultural production are currently very low. In addition, China also committed to provide greater transparency to make its domestic support measures more predictable.

China has committed to fully abide by the terms of the WTO Agreement on Sanitary and Phytosanitary (SPS) Measures, which requires that all animal, plant, and human health import requirements be based on sound science—not political agendas or protectionist concerns. Additionally, China and the United States agreed bilaterally on the terms for the removal of scientifically unjustified restrictions on imports of U.S. wheat and other grains, citrus, and meat.

The China WTO accession agreement explicitly permits the U.S. to continue to use its non-market anti-dumping methodology for 15 years after China's accession to the WTO. China also has committed to a strong product-specific safeguard that allows the United States for 12 years after accession to restrain increasing imports from China that cause or threaten market disruption. After that, current U.S. safeguard provisions—Section 201—will remain available to address increasing imports.

American farmers will benefit from expanded trading rights. Currently, only companies that receive specific authorization from the Chinese government are allowed to import into China. Under the agreement, China has committed to allow any entity to import most products into any part of the country within three years of accession. A select list of products will be partially exempt from this rule and some trade will be channeled through China's state-trading enterprises (including wheat, corn, rice, and cotton; state trading will be phased out for soybean oil). However, specific commitments to end monopoly import status have also been established. Additionally, China has committed to liberalize distribution services for all agricultural products, except tobacco, allowing U.S. companies to distribute and market their products in China.

In short, American farmers will benefit from dramatically expanded market access opportunities. American farmers will realize enormous benefits in virtually every agricultural sector, including:

—*Grains*.—China's offer for corn, wheat, and rice will lock in important and long-term market access opportunities for American farmers. China has also agreed to remove its import ban on wheat and other grains from the Pacific Northwest.

—*Oilseeds*.—Under the WTO Agreement, China has bound tariffs at a low rate for soybeans (3%) and soybean meal (5%), and to eliminate quota limits, which will significantly increase future opportunities for U.S. producers. Export prospects for soybean oil are also bright, as China phases out quantitative restrictions and liberalizes trade completely by 2006.

—*Pork*.—China is the world's largest consumer of pork, but import barriers have effectively denied access to American pork products. Under the Agreement, China will reduce its tariffs on frozen pork and offal from 20% to 12% by 2004. This reduction in tariffs, along with China's agreement to eliminate unscientific barriers, will result in substantial marketing opportunities for high-quality and competitively priced U.S. pork.

—*Beef*.—By 2004, China will reduce its tariffs from 45% to 12% on frozen beef, and from 45% to 25% on fresh/chilled beef. While China currently imports a small quantity of beef, income growth and increased consumption among the urban populations should significantly increase demand for U.S. beef.

—*Poultry*.—China is already the second-leading market for U.S. poultry exports. Under the Agreement, China will reduce tariffs from 20% to 10%—which should create a significant, immediate impact on U.S. exports.

—*Cotton*.—China is the world's largest producer and consumer of cotton, accounting for 20–25% of the world's total in both categories. Under the Agreement, China will establish a large, low-duty TRQ for cotton with a substantial share reserved for private importers, which should lead to expanded U.S. cotton sales.

—*Fruits*.—China will cut tariffs on a number of fruits and fruit products exported by the United States, including citrus, apples, and grapes, and will be obliged to remove unjustified import bans. While China is a major producer of citrus and other fruits, U.S. producers will benefit from access to major markets that are not adequately served by China's producers. China also made a bilateral commitment to lift its ban on imports of citrus fruit from California, Arizona, Texas, and Florida.

—*Others*.—Agricultural commodities as diverse as wine, solid wood products, fishery products, tree nuts (including almonds), dairy items (especially cheese), snack foods, and other consumer-ready items, can all expect to benefit from China's WTO accession.

With China's membership in the WTO, under the protocol of accession we helped to negotiate, China agreed to undertake numerous trade-liberalizing commitments which will improve market access for U.S. agriculture. We recognize that WTO implementation will present a major challenge, both for China and its trading partners. China will need to revamp its system, to rewrite and amend thousands of laws, rules regulations at the central government and provincial levels. This promises to be a long process given the complexity of the Chinese economy and import system.

With China, what seems to be the end of negotiations is often just the beginning. The effort to effectively monitor and enforce China's WTO commitments is taken seriously by the U.S. Department of Agriculture (USDA). To ensure that China meets its new obligations, USDA is in the process of establishing a permanent "China Task Force" to monitor China's compliance with its WTO commitments. The team will draw from expertise across the Department. Futhermore, we continue to work closely with our overseas posts and industry groups. We are currently planning consultations with China on their new biotechnology regulations to ensure that the new regulations do not stop trade. USDA considers this a high priority, given the importance of the Chinese market to U.S. agricultural producers.

Co-Chairman MULLOY. Thank you, Ms. Sheikh. I should have mentioned that you are a Deputy Administrator with the Foreign Agricultural Services, and you have people on the ground in China on this issue.

Ms. SHEIKH. That's correct.

Co-Chairman MULLOY. Thank you very much.

PANEL I DISCUSSION AND QUESTIONS AND ANSWERS

Commissioner Wessel?

Commissioner WESSEL. Thank you, Mr. Chairman, and I appreciate the panel members being here today.

I am trying to understand a little more about the system that we are going to use to ensure compliance with WTO commitments by China. We have seen in the last months Motorola, for example, here in the United States, one of the prime movers for the WTO accession agreement, lay off 40,000 workers and create a similar number of jobs in China. We have seen this with a number of large multinationals that are the ones who were primarily arguing for PNTR last year, many of whom are really creating what I'll call a new class of industrial tourists—sending products to China, the special economic zones, which are then coming back here with the value addition of Chinese labor, shall we call it, and then coming back here and helping to create an $85 billion trade deficit.

How are you focusing resources in terms of monitoring and ensuring compliance with the agreement? Let's take furniture, for example, where we have seen many U.S. companies, the large companies, creating facilities in China to produce it and bring it back here, but we have seen the devastation in North Carolina, in Missouri and the Boot Heel, and all across this country, where smaller manufacturers have been put out of business and several hundred thousand workers have lost their jobs.

Are you coordinating actively with not only organized labor, but workers across the country? Are you meeting with small businesses, those who were not arguing for PNTR last year? In terms of agriculture, are you talking to the National Farmers Union, the National Farmers Organization, the Save the Family Farm Coalition, those who represent small specialty products that might be swamped by some of the collective apparatus in China in terms of agricultural production?

How are we going to ensure that this is not those who have a vested interest by having production facilities in China and simply want to bring products back here, but that those who represent the smaller communities and the workers all across this country, are actually going to have their jobs and livelihoods insured in the long term?

I would ask each panelist to respond to that. Mr. Bader, do you want to start—Ambassador Bader. Excuse me.

Mr. BADER. Yes, Mr. Commissioner, if I could comment briefly on each point. First, on the point that you made about the job migration, one important objective of WTO accession to China, an essential objective, is market access for U.S. products. As my colleague from the State Department, Mr. Donnelly said, this is about Chinese market opening and not about U.S. market opening. What that means is that the $84 billion deficit that you mentioned—we think there are some macroeconomic reasons for that, but there are also market access barrier reasons for that, and the WTO accession agreement is precisely designed to address those. So we are hoping——

Commissioner WESSEL. And does that mean you expect the deficit to come down as a result of the agreement?

Mr. BADER. The numbers for 2001 that I have seen, and I just saw the first 10 months, show U.S. exports up about 20 percent, and U.S. imports were pretty flat, maybe up about 2 or 3 percent.

Given the trend lines of recent years, I think it would be wrong to look for an immediate, quick turnaround, but that the numbers of last year combined with the WTO commitments give the hope of that number turning around over time.

Anyway, on your point about furniture, I'll just touch on that very briefly and note that one of the important areas of tariff reduction in the WTO agreement is in the furniture area.

As for meeting with small business——

Commissioner WESSEL. I apologize for interrupting again—do you expect China to be buying significant amounts of U.S. furniture, then? Do you see a tremendous benefit there?

Mr. BADER. There is an old Chinese saying that "It is dangerous to make predictions, especially about the future."

Commissioner WESSEL. Excuse me—that isn't the answer, but that's okay. Go ahead. Proceed.

Mr. BADER. I don't want to give you an uninformed answer on that. Let me go back and talk to my people and get a sense—unless someone else on the panel has a better answer than I do; maybe Bill does. He can address that.

As for small businesses, I might just mention that Congressman Manzullo was just out in China, the chairman of the Small Business Committee. We briefed him before he went, and then he saw President Jiang Zemin for an hour and a half, and we were debriefed by him after they met. You are correct, obviously, that the big companies are the ones that one we usually see and hear from. However, we have established relationships with the U.S. Chamber and with the National Association of Manufacturers and the U.S.-China Business Council. In addition, we are going to try to get on the road more. I am going out to the West Coast next month to talk to the American Association of Exporters and Importers. I have four or five trips planned to try to get beyond the Beltway and talk to companies, not just at corporate headquarters, and I know that Bill and others are looking at the same kind of approach to try to get beyond Washington.

Commissioner WESSEL. The one other area is organized labor. Are you having active discussions with them—is USTR?

Mr. BADER. On that, the approach is usually through the ISAC committee approach, and there have been frequent and active discussions through the ISAC committee approach with labor.

Commissioner WESSEL. Thank you.

Mr. LASH. Mr. Commissioner, I will echo the comments of my colleague, Ambassador Bader. Number one, to get back to your question about furniture, while we cannot predict a rise or a drop in exports of furniture, we can guarantee a rise in the opportunity to purchase furniture because WTO membership will lead to, frankly, a larger group of middle-income Chinese workers. China, in the next 10 or 20 years, may have a larger middle class than the United States, and that creates the opportunity to purchase.

But getting back to your question about outreach compliance, we spend a lot of our time—and I do mean a lot of our time; I am on the road weekly—talking to small and medium-size firms on every, single trip, way outside the Beltway.

On labor, in our compliance program right now, we include eight labor unions in our compliance outreach, telling them what opportunities are going on, and we are open for business, looking for trouble. Mr. Bader's office prosecutes the cases; we investigate them. And we are always looking for more cases. We have a separate textile compliance program where we are going to textile states, talking to textile workers, textile companies. If they can show us a trade barrier in China or elsewhere that is hampering U.S. exports, we will be jumping on it.

At the same time, our compliance efforts, we have our trade compliance center that is also doing national tours of small cities, small communities. From the Secretary down, we are always doing outreach. We want to hear about the problems, and when we hear about the problems, we investigate them, and if we cannot solve them ourselves, we refer them to interagency dispute settlement. So I can guarantee 100 percent that we are dedicated to finding problems like this, and we are dedicated to working with unions as well as with corporations, large and small. We have actually managed to have great outreach to NFIB, the National Federation of Independent Business. I have actually hired one of my staff members to focus on going out and talking to small and medium enterprises about the opportunities and about the message of compliance with this Administration. We are dealing with absolutes.

Co-Chairman MULLOY. Commissioner Wessel, we can come back, but I have really got to be fair and move it along now.

Commissioner Robinson?

Commissioner ROBINSON. I have just one question for any of the panelists, and it has to do with the bottom line assessment, if you will, whether you believe that the U.S. trade deficit with China is likely to continue to grow. This would be consistent, as I understand it, with an estimate of a report that I haven't had the benefit of reading, but the International Trade Commission on WTO Accession of September 1999, which I understand had that as one of its bottom lines, and if so, if any of you have that view, whether the continued growth in our trade deficit in your view would be sustainable politically. I am thinking specifically of a strong temptation, for example, by the Congress to take remedial actions that may not be consistent with WTO rules.

Do you have any observations on how you see or can crystal-ball that one?

Mr. LASH. Obviously, as Jeff said, predictions are extremely dangerous, but on questions of the deficit, I harken back to the report of the Trade Deficit Review Commission, which itself came up with a mixed report as to predictions—after studying it for about a year and a half—as to whether the deficit was going to grow or not, or the danger or lack thereof of the deficit growing.

I think that the deficit question with China defies quick and easy answers. We have to look at what is being sold and what is being exported. Again, we are selling typically higher-tech, higher-value-added systems. We now have new market access incentives like agricultural products where we are very optimistic. At the same time, Chinese exports to the U.S. have been consumer goods largely of broad appeal, from gadgets to clothing and toys.

So it will be interesting to see what WTO brings as far as market access, as well as economic growth and stability for the Chinese market. Will it create, again, a booming middle class that will be able to demand, frankly, higher-end goods?

Mr. BADER. Mr. Commissioner, if I could make a comment, too, I agree with what Bill said. I think we are going to be looking at substantial deficits for some time. I think that we would be deluding ourselves if we did not expect that.

The tremendous growth in the deficit over the last decade was partly a result of growth of China's economic power and also partly a result of the creation of the greater Chinese economic area, with accompanying migrations of deficits from Taiwan and Hong Kong, or bilateral deficits vis-a-vis Taiwan and Hong Kong to the mainland.

If you look at, for instance, the move of the information technology sector of Taiwan substantially to the mainland in the last couple of years, there has been about $9 or $10 billion in IT investment by Taiwan in the mainland, and those are numbers that would have shown up as a U.S.-Taiwan deficit a few years ago, and now they are going to show up as a U.S.-China deficit.

So it is a complicated picture, as Bill said. Although we do point out to them precisely your point about the political unsustainability of deficits of this character over the long run, our principal focus is on market access barriers. We don't really mind buying from the Chinese as long as they will buy from us, and if we can use WTO to break down those barriers, that's the objective.

Ms. SHEIKH. If I could say something from agriculture, of course, I don't want to take on the macroeconomic question that you raised, but certainly at a micro level, dealing with the agricultural sector, we look at this agreement as leveling the playing field. We did not have access to the Chinese market; they had access to us. This agreement allows us to level that playing field and get into those markets where there is demand for these products.

Commissioner ROBINSON. Thank you.

Co-Chairman MULLOY. Thank you.

Chairman D'Amato?

Chairman D'AMATO. Thank you, Mr. Chairman.

I want to thank the panel for coming and thank you for your testimony.

Secretary Lash, I just want to point out that the resources for new personnel that you got as a result of Commissioner Mulloy was courtesy of the previous commission, the Trade Deficit Review Commission's, recommendations.

Mr. LASH. I appreciate that very much. I am also very mindful of that.

Chairman D'AMATO. And not only their recommendations, but their help in making sure that Members of Congress knew that it was an important issue.

Mr. LASH. Yes.

Chairman D'AMATO. And we discovered that the Clinton Administration had negotiated about 350 trade agreements, which was roughly one a week for 8 years, and we were just wondering how they were being enforced.

Anyway, Ambassador Bader, I have a question for you. I want to commend you on the institutional creation that you have engaged in across the board in the government to ensure compliance with this very difficult treaty by the Chinese. I also recognize that this Commission visited China and talked to a lot of economic officials, and clearly, the leadership is prepared, as you say, to take on a challenge and is committed to take on a challenge.

But there is a question here, as I think you point out, of capability versus will. One American diplomat in China told us that he felt that Chinese ability to regulate their laws and authorities was basically line-of-sight from Beijing. That may be an exaggeration, but the question, of course, is whether they are putting into place in China the institutions in China and whether or not we can help develop joint institutions not just to monitor the Chinese but to participate with the Chinese on a sectoral basis, let's say, or even on a provincial basis. I mean, some of the States of the United States would be glad to have their sister provinces develop—and I say this seriously—institutions that could be monitored and managed on the State and province level, because I think a lot of it is going to be the problem, as you pointed out, at the province level.

So the question is whether you have thought through institutional creation at the bilateral level of the United States and China to speak of, various sectors, and to monitor their compliance. And then, one subsidiary question. We understood when we were there that the Chinese had not yet promulgated in China the text of the WTO agreements for people to look at and understand what it was that they had agreed to. Has that been promulgated to your knowledge, and what about the institutional creation that I am suggesting?

Mr. BADER. I think the point you make about institutional creation is very constructive and very interesting one. I would like to talk to you more about that. I think that is a very interesting one, particularly your suggestion about the state and provincial relationship. I have to say candidly that that is something that I have not dived into, and I think that is a very good idea.

I know that when I was stationed in Hong Kong, we used to have a steady stream of port associations and state and city, governor and mayor-led delegations that were establishing relationships with the Chinese, and now that we have WTO in place, I think you are absolutely right that we ought to try to get them to segue over, not only to looking for market opportunities, which is what they have usually done, but also to look at compliance issues. I think it is an excellent idea.

In terms of institutional creation, I think we also have to look at technical assistance and see if there are more things that we can do than we have done in that area so far. The Department of Commerce—and I won't speak for them, since Bill is seated next to me—but the Department of Commerce and State and USTR all have their hands in there, and the Trade and Development Administration has also been looking at WTO implementation and technical assistance programs.

Texts of WTO agreements have been published in China, and they are published in Chinese.

Chairman D'AMATO. Thank you.

Co-Chairman MULLOY. Commissioner Bryen?

Commissioner BRYEN. I want to return to the question of deficits, if I may, and before I do that, I thought I heard Ambassador Bader say that he estimated that our trade with China was 20 percent in the next year; is that correct?

Mr. LASH. I hate to be Jeff's counsel, but he actually said that our exports increased 20 percent this past 10 months, while the Chinese part of the deficit had dropped 3.4 percent.

Mr. DONNELLY. Our exports to China compared to our imports from China.

Mr. LASH. Right.

Commissioner BRYEN. Commissioner Robinson was referring to a 1999 study by the International Trade Commission which figured that as a result of WTO, our exports to China would go up about 10 percent, and their exports to the U.S. would go up about 7 percent; but the problem is, of course, that their exports to the U.S. are eight or ten times more than our exports to China, which means that the deficit gets bigger.

Commissioner LEWIS. Seven percent is bigger than 10 percent is what you're saying.

Commissioner BRYEN. In this case, yes. This is the "new math."

So what I want to know is first of all whether you agree with that assessment and whether that is a long trend. In other words, does that continue out in time in your estimation, because if it does, then we have an even wider deficit. At some point—I can see clearly the benefits in the agricultural sector, because I think that sector has been deprived of access to the market, so that can only be a positive. But in some of the other sectors, it is quite the reverse. So the overall impact on the economy, it seems to me, is potentially quite negative, and I would like to get your reaction to that, starting with Ambassador Bader.

Mr. BADER. Mr. Commissioner, I completely agree with your "new math" point, and that was the point that I was making slightly more obliquely than you just made it directly. That is why it is going to take a while, a fair amount of time, for these numbers to turn around, because as the Commissioner pointed out, 7 percent is more than 10 percent when you are dealing with one big number and one small number.

That is why, although I am optimistic about WTO helping us with market access barriers, I am not optimistic that that is going to make this oceanliner turn around quickly.

Mr. LASH. I concur with Jeff on that 100 percent. Again, the WTO was not designed to address the trade deficit; it was designed to increase our market access and to increase, frankly, a level playing field with the rule of law so that our exporters and our workers can get a fair deal when trying to export to the Chinese market.

Mr. DONNELLY. If I could add, there clearly are some economic problems between ourselves and China. There are macro problems with the deficit, there are micro things, whether it is furniture or sectors; they would be there whether or not China had joined the WTO. And because our economy is much more open to Chinese things now, I think the new opening is much more on their side. It is going to take time. It is not clear how we are going to get there. But I think getting them into the WTO gives us some important new tools to try to keep working on these things, but it is not going to turn around quickly is my opinion.

Commissioner BRYEN. So other measures are going to be needed to deal with the overall imbalance in trade; this is no panacea at all for that problem—in fact, it makes it worse.

Mr. DONNELLY. Yes, it helps but is no panacea.

Commissioner BRYEN. Thank you very much.

Co-Chairman MULLOY. Thank you.

Commissioner Lewis?

Commissioner LEWIS. I have two questions, and Patricia, I'm sorry, they don't really refer to agriculture.

Ms. SHEIKH. That's okay.

Commissioner LEWIS. The two questions—and I would like each of you to answer them—number one, market access is one thing, but the decision about where to buy is another thing. To say that our exports are small and the imports are large is really an understatement. When we buy from them $100 billion and we sell to them $15 billion, that is really not two-way trade. That is a dramatic difference. It is probably the greatest deficit in the history of the world, and it is not massive two-way trade the way our trade with Japan is.

What I am concerned about is that they buy less from us than they buy from Europe, but they sell us a lot more than they sell to Europe. What will WTO or the United States Government do to correct the buying decisions of the Chinese, which I am sure are not all coincidental, because they are now the second-largest holder of Treasuries in the world, so they are amassing huge amounts of Treasuries. That's number one.

Number two is I served on an earlier Commission in which intellectual property rights was one of the major issues, and there is no question that there is massive piracy going on of movies and intellectual property rights, and the Chinese deny that the piracy is going on; we tell them where the factories are, and they deny there are factories there. We take them to the factories; they close the factory and open another one.

There is no question that piracy is on a vast scale in China, which deprives America of jobs and billions of dollars. What will

WTO compliance requirements do to reduce this outrageous piracy and particularly movies?

The reason I am asking this panel that question, even though that subject will come up later, is because this is the only panel on which there are Government officials.

Mr. LASH. I must have lost the toss, I guess.

Commissioner LEWIS. Since this doesn't refer to agriculture, I'll leave Patricia out of this one.

Mr. LASH. I'll take the second question first on IPR protection. Jeff actually was obviously one who negotiated with China on IPR. I think the Chinese are actually very much aware. Again, I mentioned earlier my preconceived notions that I had also been a firm believer that there was widespread piracy—and there still is widespread piracy—but I don't see a Chinese Government that is turning its back on it. They recognize it.

When I was in China, there were arrests every single day of pirates.

Commissioner LEWIS. And were they released the next day?

Mr. LASH. I was only there for four days, so I don't know. But the bottom line is that in China and in most of our trading partners where there are IP violations, we have been taking a very strong message that it is not just enough to have a law. We want to see enforcement, we want to see sentences, we want to see fines, and we want to see the means of production destroyed. That has been the message from this Administration from day one on IT.

IT, unlike other trade law, is frankly an absolute. You know that it was not your patent.

Commissioner LEWIS. What about the trade deficit with us versus Europe?

Mr. LASH. Right and again, it is actually more a question, I think, of trade advocacy. I think the WTO has given us a good chance to engage the Chinese counterparts, but we are seeing more and more high-level government officials engaging the Chinese as they shift behavior. We are seeing more of our trade missions going to China from our States, from our industry groups. We are seeing more, frankly, of our leadership engaging in actual trade advocacy.

Commissioner LEWIS. In addition to just access?

Mr. LASH. Exactly.

Commissioner LEWIS. Very good.

Mr. LASH. It is much more a question of we must get there and actually make sales.

Commissioner LEWIS. That would then reduce the deficit.

Mr. LASH. It definitely would help, yes.

Commissioner LEWIS. Go ahead.

Mr. DONNELLY. This is certainly important, and another part of Ambassador Randt's strategy in China is trade promotion, trade advocacy on big deals, small deals. The foreign commercial service, the whole embassy and consulate staff have this mission, which is related but not identical to the WTO accession issue. Once we have this opening of the Chinese market, we have to take advantage of it and get in there and compete and have our senior officials advocating on behalf of U.S. firms when they are bidding against Japanese or European companies for contracts. It is not a new idea, but there is a particular vigor on this.

Commissioner LEWIS. How about piracy?

Mr. DONNELLY. Maybe Jeff should address that, but that is certainly a problem. I know that the Assistant USTR for Intellectual Property Rights Joe Popavich, is leaving tomorrow on one of his regular inspection trips to keep this issue at the top of our agenda; but maybe Jeff should comment on that.

Mr. BADER. Thanks, Shaun, for mentioning Joe's trip.

China is obligated to conform with TRIPS upon accession. That is a clear obligation. That gives us a standard that we will hold them to. It is something that we can go to dispute settlement when and as necessary, and we have done so with other countries.

I think you are absolutely right about the magnitude of the problem. The major problems, from businesses that have visited with me, that I have heard about in the last six months have been in the area of trademark violations.

Commissioner LEWIS. I am talking particularly about movies, though.

Mr. DONNELLY. Well, we have greater market access——

Commissioner LEWIS. And CD–ROMs.

Mr. DONNELLY. —yes, those are continuing problems—but we now have greater market access for movies, and the Chinese are now obligated to be open to importing more American movies than in the past under this agreement. We also have enhanced distribution rights for American audiovisual products as well.

Commissioner LEWIS. I am talking about piracy.

Mr. DONNELLY. I understand, but when you get market access, you help reduce the demand for pirated products. But I think the critical long-term component here in China to fix the problem is that the Chinese are beginning to understand that IP is their problem and not just our problem. As I mentioned earlier, they are getting into software manufacture, and they have an entertainment industries, and Chinese creators of software are concerned about what is going on. If we can form coalitions with those people, sometimes it is more effective to work with people on the inside whose ox is gored rather than just people from the outside. That is part of the strategy.

Commissioner LEWIS. Could you give us a report after this meeting is over on what is being done to stop the piracy?

Mr. DONNELLY. What is being done by the United States?

Commissioner LEWIS. Yes, by the United States.

Mr. DONNELLY. Yes, certainly.

Commissioner LEWIS. Thank you very much.

Co-Chairman MULLOY. Thank you.

Commissioner Reinsch?

Commissioner REINSCH. Thank you.

Welcome back, Ambassador Bader, belatedly—out of the frying pan into the fire, probably, but I am glad you are here.

There is probably no reliable answer to this question, but I think it is a chance for you to say the obligatory tough thing so we can get those on the record and move on.

I think that at least three of you and perhaps all of you said that there will be bumps in the road, and I do not think there is any dispute about that; we have bumps in the road with economies that are a lot closer to ours. So I guess what I want you to reflect on is what do we do when we hit the bump—and inevitably, we will hit bumps sooner rather than later. I am thinking about the 15 years that we spent dealing with Japan on various bumps in the road, with enormous amounts of energy and marginal results until, frankly, I think we all got either bored or tired, one or the other, and didn't spend as much time on it. And now, here we are, about to enter what I suspect is going to be the same exercise, without as many unilateral tools, certainly, and with the dispute settlement mechanism of the WTO that I think is problematical, although you might want to comment on that.

What are we actually going to do when we hit a bump? Are we just going to have endless rounds of negotiations with no results, or do you have some tools, and what is your intent about using them?

Mr. BADER. We have lots of tools, and we will find out over time which are the most effective. The dispute settlement is, of course, the ultimate and definitive one, but I agree with your point about its suitability for any and all purposes. As I mentioned earlier, 18 months is the fast track on dispute settlement, so it is not going to be your weapon of choice in all instances.

We have had some instances already in the six weeks since China got in where we are seeing either noncompliance or slow compliance, so we are already facing these kinds of questions, and we are discussing among ourselves, and in the TPSC context, what is the best way to deal with them.

Ambassador Randt is going to be a major weapon. He has been in already on one issue where the Chinese have not yet complied, on TRQ implementation. So we have had him.

Bob Zoellick is not shy about making it clear—he is not shy on anything, but particularly not shy about making it clear that there will be consequences when our products are blocked by China and that we are not looking at things in a purely multilateral way, but we have bilateral options.

Commissioner REINSCH. What kinds of consequences are you contemplating?

Mr. BADER. I don't know if this is the forum to get into it, but trade is a two-way street. Ambassador Zoellick has made that very clear to the Chinese, that if our products have problems, it is a two-way street. He has made that point very clear.

Commissioner REINSCH. That is very reassuring.

Secretary Lash, do you want to make a comment as well?

Mr. LASH. I would definitely agree with Jeff on that. Trade is a two-way street, and again, I think it is not wise to discuss options or weapons in a public forum, but again, Ambassador Zoellick is by no means a shrinking violet, and Secretary Evans is extremely dedicated to using all the weapons of the Department of Commerce's arsenal to make sure that we have a two-way street.

But at the same time, our dialogue is still ongoing. Our JCCT, our Joint Commission on Commerce and Trade, that Ambassador Randt, who was formerly in the Department of Commerce, and we are very proud of him as well—that gives us a chance to engage at a very senior level on specific trade problems. And I think something that Jeff and Shaun have both touched on is that our counterparts are very mindful of this and would like to avoid problems.

It is not particularly a question for China of economic retaliation or gain; it is also, I think, a question of political prestige. They would like to be responsible at the leadership level.

Commissioner REINSCH. I understand that, but we know we are going to have some.

Mr. Donnelly or Ms. Sheikh, do you have any comments?

Mr. DONNELLY. I would just add, as has been said before, that nothing that we had on the table in terms of U.S. trade laws or anything else, any of those tools, has gone away; they are still there.

I think we do have this Transitional Review Mechanism in Geneva under which the Chinese will be subject to very intensive review on how they are living up to all the commitments, which gives us a possibility, if we do it right, to build multilateral support, because other people will share our interest in seeing some of these issues addressed.

So I think that is another aspect. It isn't a panacea, but it gives us another tool that I think can help to avoid these being purely bilateral issues.

Ms. SHEIKH. I would just say that I think it is a bilateral/multilateral effort, and I think that on the bilateral end, certainly we have described to you the interagency process where all of our senior-level officials are ready to be engaged in this process if necessary. But I do think that what Shaun has said about the multilateral forum and China being scrutinized not only by the United States but by other trading partners will probably have more beneficial aspects for the U.S. than us going after them alone. We shouldn't shy away from multilateral engagement, because in numbers come strength. Consequently, I think we really need to look at how engage in the multilateral discussions with the Chinese and our other trading partners.

Commissioner REINSCH. Thank you.

That is very helpful. I have to say that I liked all of your answers, but I think I liked Ambassador Bader's answer the best.

Thank you, Mr. Chairman.

Co-Chairman MULLOY. I think that was a very helpful exchange, that particular question and the answers.

Commissioner Dreyer?

Commissioner DREYER. I'd like to go back to TRIPS for a moment. Did China try to negotiate a delayed implementation of TRIPS?

Mr. BADER. Commissioner, I have just been doing the last 8 months of the negotiation. I know the outcome. I don't remember the whole sequence before that, but I know that the outcome was that they did not succeed upon accession. Whether there was an earlier effort to try to stage it, I don't recall, frankly.

Commissioner DREYER. Would anyone else have any recollection of that?

Mr. BADER. I can get back to you on that if you wish.

Commissioner DREYER. Yes. I would really like you to. That is important to me.

The other question I had was really asked by Commissioner Reinsch, but are you prepared to deal in any way with what I have noticed is a very typical Chinese response to other instances, which is you agree in principle, and then you drag your feet and delay as we saw, for example, with the ring magnets. Then, you argue that, well, we didn't know about it, and therefore, there is nothing we can do about it, and there is the Chinese proverb, "Heaven is high, and the Emperor is far way"—meaning that if you can get away with it, Beijing can pretend not to see it and therefore doesn't have to deal with it.

Are there any contingency plans in place to deal with what I see as the inevitable argument that is going to be made?

Anybody? Secretary Lash, I think you lost the coin toss this time. [Laughter.]

Mr. LASH. I feel like the odd man in the middle. Again, I'll take the question you threw out about the typical response, because although I was out there doing some bilateral negotiations on a large list of issues across the table with my counterpart, and on certain things, frankly, I did not have the strongest legal case on a payments problems. They were not questions of WTO accession—purely a commercial dispute between one of our companies that I was trying to get some payments for—and they made a very large payment to a small company.

On other issues, I will say that we got some other victories. On some things, it was simply a draw, like any other trading partner. I find that China in this regard, with regard to problems, is like almost any one of my trading partners. Fortunately or unfortunately, I have global jurisdiction for compliance. I find the same patterns with China as I find why anyplace. We simply have larger patterns; that might be the only difference.

But for all those questions, we are still willing to do anything it takes to get compliance.

Commissioner DREYER. Ms. Sheikh, we had the soybean manufacturers and exporters here this summer, and they were looking forward to WTO because of soybeans. Now we hear questions been raised about whether these are genetically modified soybeans, and if they are, of course, China wouldn't want genetically modified soybeans. And I see this as an example of the drop of water on the rock kind of thing.

Commissioner LEWIS. Wheat is the same thing.

Commissioner DREYER. Yes, wheat.

Have you met with anything like that, or is this a concern of the Department of Agriculture?

Ms. SHEIKH. Well, we have a long history with TCK wheat, so we know how the Chinese can take an argument and drag it out.

Commissioner DREYER. Yes, exactly.

Ms. SHEIKH. Certainly, there are concerns about soybeans. Certainly, there are concerns about these genetically modified organisms. And we have already seen some indication that China might resist to fully abide by what they agreed to in the WTO in terms of publishing regulations, and in terms of allowing other trading partners sufficient time to comment.

I think we have to engage the Chinese in a dialog in an attempt to turn them around and remind them of what they have agreed to in the WTO, and if they don't comply, we then have to decide on our options as to what we are going to do. But we are going to use the WTO rules and regulations that they agreed to, hopefully, get them to abide——

Commissioner LEWIS. They may first deny they agreed.

Ms. SHEIKH. Pardon me?

Commissioner LEWIS. They may first deny they agreed, so you have to point out what they agreed to.

Ms. SHEIKH. That's true, and we recognize that this is a long haul. It took us 20 years to fight the TCK battle with them, which was based on nonscientific reasons, so we understand that these ways of handling issues are very prominent in China.

Commissioner DREYER. And what do you mean when you say "consider our options"?

Ms. SHEIKH. Well, I mean within the interagency process. It's not just the U.S. Department of Agriculture alone. USTR has a stake in this; State would have a stake in this. We would have to look at where we are after discussions with the Chinese in terms of reminding them what they agreed to in the WTO and how this process is supposed to be worked out in terms of promulgation of regulations.

Mr. BADER. Commissioner Dreyer, if I could say a word on this because I think it does get to the point that you are raising about how we deal with the Chinese when a problem arises.

This one, we have been acutely aware of since the Chinese put in place a new regulation last June that essentially called for testing and inspection of biotech products, which basically ground soybean exports to a halt from June until September.

Ambassador Zoellick raised the issue I would say forcefully with Ambassador Yang, very forcefully, and then with MOFTEC Minister Shi Guangsheng in Shanghai. He wrote to the Minister about it. I know that Secretary Veneman was taking a parallel approach.

The President, when he met with Jiang Zemin in Shanghai in October, also discussed the problems in this area.

As a result of a rather aggressive approach, the Chinese responded by agreeing to accept on a temporary basis U.S. certificates of the safety of biotech products, and the trade resumed in October. Indeed, the trade levels in October, November, and December I am told were at record levels.

Since then, the Chinese have announced that they are implementing regulations to the initial regulation, and they will go into effect March 20. Like the initial regulation, they remain vague; there are gaps in them. We are concerned about them. We think that if they are implemented improperly, they could be a barrier to trade. As a result, we are sending a technical team out in the next few days to talk to the Chinese about it, and we are giving this political-level attention and communicating to the Chinese, essentially saying, "Whatever you do in this area may not be a barrier to trade." So it is being taken very, very seriously, and you are right to highlight it.

Commissioner DREYER. Thank you.

Co-Chairman MULLOY. Thank you.

Commissioner Becker?

Commissioner BECKER. Thank you, Mr. Chairman.

I don't know whether to be pleased, Ambassador Bader, with your statement in here or not. I am referring on page 3 where, in concluding on that particular area, you say, “Before moving on to the next topic, let me add one further thought. It is also quite possible, if not probable, that independent of these internal struggles”—and the “internal struggles” that you are referring to are the ability or the capability of the Chinese to comply—“China will simply be unwilling to live up to a particular WTO commitment.”

When the debate was going on, when we were engaged in the debate on WTO and the accession of China into the WTO, I heard testimony at different congressional fora from knowledgeable people that the Chinese had never, ever lived up to any commitment they made to the United States; whether it be any of the independent agreements or the trade commission that were sent, they simply did not honor those and live up to it. So that brings us up to the point. I wish that that statement had been made by USTR before the accession, and that could have been discussed—exactly as you said here—because when you talk about consequences of failing to comply, again, there has been testimony before this commission and a prior commission that I was on by steel executives that they have yet to ever ship steel successfully into Japan, in spite of the WTO commitments, in spite of the promises. We have simply been unable to get this done.

So I don’t know how we deal with those consequences. And Commissioner Lewis raised the question on piracy. There have been agreements on piracy with China.

Commissioner LEWIS. Many, many.

Commissioner BECKER. And there are no consequences to date with that. So we are very concerned about that. I just want to say that and make that comment.

But more specifically, within the WTO agreement will they continue with the state-owned enterprises, and will they be able to continue with the PLA-owned enterprises? Is there provision to eliminate that within the WTO, and can we expect enforcement in that area?

Mr. BADER. Commissioner Becker, there are provisions about state-owned enterprises in the WTO agreement. The thrust of those provisions and those commitments compel state-owned enterprises to make decisions on a commercial basis rather than subject to political guidance. In addition, there is an elaborate discussion of subsidies and the issue of industrial subsidies and subsidies to state-owned enterprises, because as you know, the state-owned enterprises in China have benefitted from an elaborate array of subsidies, usually through bank loans that were never repaid.

So that issue of the state-owned enterprises will continue to exist, but they will be subject to the disciplines of the WTO and therefore, again, subject to all the mechanisms that we have described in terms of U.S. and multilateral response.

In terms of the PLA, I don’t recall any specific references to PLA in the WTO agreements. I think they would be—I will talk to my general counsel’s office—I assume that state-owned enterprise provisions would apply to PLA enterprises. As you know, there is no long history of back and forth within China about getting the PLA out of business, which had erratic results.

Commissioner DREYER. A perfect word.

Commissioner BECKER. Thank you for that.

Secretary Lash, is there anything you would like to add in that regard?

Mr. LASH. I agree very much with Jeff, but I also think that WTO—I'll get back to their obligations—Jeff was hitting on the points of the state-owned enterprises, and you have raised them as well. I think that as we force China to open their own market, and we see increased pressure as private enterprise develops, basically, you are seeing two banking systems develop where you find more pressure on state-owned enterprises, frankly, falling behind as banks and other decisions are made on market-based decisions rather than political decisions. I think we will see more opportunity for U.S. firms. Of course, both politically as well as economically. It has to happen.

Commissioner BECKER. Thank you.

Then, I have a question for Mr. Donnelly. There was a lot of concern expressed before the WTO accession was accomplished concerning human rights, women's rights, labor rights, and in a very candid exchange with Ambassador Albright, she said to a group at which I was present that the best way to advance democracy in China was to have American presence there in the form of businesses and let the businesses practices and the business influence within China help bring these about.

In that regard, I want to raise a couple of questions, because I have been told—I did not realize this before—that the law in China requires all companies—Chinese companies and I assume American companies that are headquartered in and operating in China—have to comply with Chinese law—requires them to report pregnancies of women who are working in the factories, because they have very strict requirements on family size, and they use this as a method of control, and to report members or employees who are practicing the Falun Gong religious ceremonies during their off time from work.

My question, then, is whether or not the government has any knowledge of this, and has this been raised by any American companies that are operating in China, and what kind of advice is being given to these companies in that regard?

Mr. DONNELLY. Commissioner Becker, clearly, we have had, we have long had, and we still have problems with the Chinese Government related to human rights, related to freedom of religion. We continue to work on these. We raise them with the Chinese at all appropriate occasions. I do think, and I believe the Department of State believes, that over time, integrating China more into the world system—business, more exposure to international things, more exposure to the internet—is going to help in terms of bringing them toward world standards. It is not going to happen overnight. It is not easy. It is not a simple solution. But I do think that that can help.

On your specific question about companies being required under Chinese law to report pregnancies or practice of religion, I am not aware of that. I am not a China expert. I'll go back to our people who follow China on a full-time basis and get you an answer to that.

Commissioner WESSEL. Would the gentleman yield for a moment? Would you provide us with a list of any companies that are in fact refusing to abide by Chinese law so that we can understand whether in fact they are doing what we would hope they would do, which is spreading democracy?

Mr. DONNELLY. I will, with my colleagues on the China desk, get you all the information that we have on this, and as quickly as we can.

Commissioner WESSEL. Thank you very much.

Co-Chairman MULLOY. With that particular question by Commissioner Becker on the pregnancy and the other issue, if you could submit that one in writing, I think that will be very important.

Mr. DONNELLY. Yes. Will do, Mr. Chairman.

Co-Chairman MULLOY. Thank you.

Commissioner BECKER. Falun Gong and the other.

Mr. DONNELLY. Okay.

Commissioner DREYER. And since we are asking for things in writing, Ambassador Bader, could I ask you for the answer on TRIPS in writing? Thank you.

Co-Chairman MULLOY. Commissioner Waldron.

Commissioner WALDRON. Thank you, Mr. Chairman.

I'll start by making a couple of remarks, and then I want to pose a question to you. As I ask myself what is the bottom line of this hearing, what I come up with is that basically, things are going to continue into the future as they are now—in other words, that those deficits that we have been talking about are going to be out there for a very long time.

The second thing that I conclude is that we have basically no leverage. Several people have talked about the harsh consequences that will follow, but when we investigate that, it turns out that they are mostly a matter of using personal influence with Mr. Zoellick or with the President or whomever. And obviously, that is not a generalizable approach.

One of you—I think it was Mr. Donnelly—mentioned the internet. I was just told by my colleague here that the Chinese have just closed down this Commission's website. I think it is important. There are a lot of hopes riding on the internet, and I think some of them are going to be disappointed.

The only real leverage that we have is to do something that we are not allowed to do under the WTO, which is to limit Chinese market access to the United States. That is the only way to do it is to start excluding Chinese goods until they start importing more American goods. But by joining WTO, we have given away that leverage.

And the third thing I notice, and I have to say that I am a professor of history, so I read lots of old stuff. Despite these two, to me, rather problematical conclusions, there is an underlying sense of optimism, I would say, among the four people testifying for the Government. China is going to come right; it is going to be a long and difficult process, but over time, as we engage them more completely in the world, et cetera, et cetera, things are going to go well, which I would say is an untested hypothesis, and furthermore, it rests on some dubious assumptions.

The first thing I would point out is that China is a country which does not even have a mechanism for choosing its own leadership. In other words, there has been no transition of power in the entire history of the People's Republic of China which has followed even the written regulations and provisions of the Chinese Constitution and other documents. And the way that things are shaping up before the upcoming Party Congress suggests that that continues to be so.

Second, China is a country which has in effect no legal system. There is a great deal of talk about Chinese laws, but in my own many discussions with people about how conflicts have actually been resolved in China to the satisfaction or to the acceptance, at least, of both parties, there has never been one case in which someone has said it was resolved according to the procedures that it was supposed to be resolved by—in other words, say, through law courts or something like that. It is always informal.

So given that, given that a country does not even have a system, really, for governing itself, it is highly unrealistic to imagine that simply signing a set of international obligations is suddenly going to transform that domestic system.

Rather, I think we should say that things will continue, and this will simply be one more piece. And let me give you just an historical example. This is not the first time that U.S. or foreign goods have had difficulties accessing China. For the period before 1949, there was a system of local taxation which was entirely illegal under Chinese law called "lijin," the infinitesimal tax. This caused great irritation among merchants, both Chinese and foreign, and there were all sorts of national and international hearings on "lijin" and on the abolition of the "lijin" system and so forth and so on, and it never really was in fact abolished.

Whenever I hear people talk about WTO, I always think about the "lijin" system. And I have noticed—I am a member of an internet chat group on WTO, and one of the things that was noticeable once the great act actually occurred was that the tone of the people who had been strongly in favor of WTO suddenly changed. They had been saying this is going to be fantastic, this is going to be a great leap forward, it is going to be transformative, it is going to be qualitatively different, et cetera, et cetera; and then, all of a sudden, they are saying, well, of course, it is going to be a long haul, it is going to be hard work. There are lots of bumps in the road ahead. You have to understand the complexity of Chinese society, et cetera, et cetera. And I thought, well, they are preparing us for something, and what they are preparing us for is disappointment.

But also, as a student of the way China—and I don't mean here the Chinese people; I'm talking really about governments and the various informal groups that loot the Chinese economy and so forth—the typical thing that happens when China joins an international organization or subscribes to a set of principles is not that it enforces it on itself, but rather that it uses the provisions of that new agreement to try to extract more from the other members of the organization. That was certainly true with the League of Nations; that was true with a variety of international commissions in the pre-1949 period.

So what I would expect under WTO would not be that China would suddenly start working on removing obstacles to market access in China. I think those will continue. What they are called—

it may be of great interest and importance to people working in the State Department or the Department of Commerce to find out what the changing names of all these barriers are. But what they will do is try to turn the WTO provisions against the United States, against Europe, against other countries, to their advantage.

And what I would like to ask any or all of you to comment on is what are some of the ways—and I have already mentioned that by joining WTO, we have given away the only serious leverage we have, which is restriction of market access. That, they understand. But what are some of the ways that China can use WTO against us and against Europe, against Japan, and so forth?

Mr. LASH. I'd like to start by trying to address Commissioner's Waldron's—he mentioned he is a professor; I couldn't tell whether there was a question or a lecture somewhere in there——

Commissioner WALDRON. Well, as I said at the outset, it was a statement, because you are obviously not a specialist on this. I wanted to fill you in on a little background, and then I wanted to pose this question.

Mr. LASH. Well, I appreciate your patience with that very comprehensive statement.

Commissioner WALDRON. Thank you.

Mr. LASH. As a professor, I could tell it was obviously history and not law or economics, because I have never heard this panel say we were giving up our leverage with the Chinese. I never heard the panel saying this was purely a question of personal relationships dealing with the Chinese. In fact, our trade laws are still very much in effect from 301 to Special 301 directed totally at IP violations, whether China or anyone else——

Commissioner WALDRON. No, I——

Mr. LASH. —may I please continue——

Commissioner WALDRON. Sure.

Mr. LASH. —thank you—our unfair trade laws from dumping to CVD are still very much on the books. No one on this panel has advocated and no one in this administration has advocated stepping back from there.

Frankly, it would be irresponsible to give the suggestion that we have lost leverage. Frankly, WTO gives us more leverage. As my colleagues have stated, it gives us a chance to engage China not just bilaterally, but multilaterally in this forum, not just with their own unfair trade laws but with other unfair trade laws.

And I will state—again I appreciate your patience—that when I have dealt with our other trading partners, whether Japan or the EU, one of the things they are always interested in discussing is how we can multilaterally engage, monitor, and promote compliance with WTO regulations by China.

I am sure Ambassador Bader has some thoughts as well.

Mr. BADER. Just one addition to what Bill said. In the WTO agreement in terms of our trade laws, on anti-dumping, on special safeguards, and on textile safeguards, we have specific provisions in the WTO agreement. I think perhaps it was Ms. Sheikh's testimony that referred to the non-market methodology in the anti-dumping area. We can use that for 15 years, and the burden is on the Chinese to demonstrate that a particular sector is in fact market.

In the safeguards area, we have 12 years in which we can use a China-specific safeguard, which is unique. Normally, when you are imposing a safeguard, you have to restrain imports from all countries where there is a surge. In this case, we can target China specifically. And there is also a textile-specific safeguard, good until 2008.

So the WTO agreement allows us to use some of the tools that Bill mentioned, and indeed, I would argue, strengthens their possible utility.

Commissioner WALDRON. Could I just ask a question? Could the argument be made under WTO that given the principles of free trade and all the rest, provisions such as 301(c) and all the rest are in fact in violation of WTO? Could one make such an argument?

Mr. LASH. They would lose the argument.

Commissioner WALDRON. Wait a second. Could they make the argument? How would they lose it?

Mr. LASH. They could not make the argument, because it has already been tried and answered. The case has been brought to the WTO dispute panel. A student of law or economics would have already known that. It has already been adjudicated.

Commissioner WALDRON. Well, let me just add—I am very interested—how many——

Mr. LASH. And——

Co-Chairman MULLOY. Excuse me. In order to stay within our time limits, what I would suggest, Commissioner Waldron, on that particular issue, whether 301 or Special 301 are consistent, or whether they can survive our WTO and China's WTO accession. Why don't you submit that in writing for the record?

Mr. LASH. Mr. Chairman, it has already been adjudicated, though.

Co-Chairman MULLOY. That's a very important issue.

Mr. LASH. Mr. Chairman, it has already been adjudicated.

Commissioner WALDRON. Could I add something—could we have a list of all the powers that we have to restrict Chinese imports and the number of times that they have been used?

Commissioner WESSEL. If I could, just as a point of clarification, because this is an important point that Mr. Waldron and Mr. Lash are discussing, there are issues regarding bound tariffs, there are issues regarding 301 and the concurrent filing at the WTO. So while many of those laws remain on the books, the question of the utility has been called into question by many, so there is some truth on both sides in terms of the intent of the question and the intent of the response.

Co-Chairman MULLOY. And that is why I think it is very important to put that in writing. And if you would like, we could probably formulate some questions to you in writing for a response.

Would that be a way to do it, Commissioner Waldron?

Chairman D'AMATO. I think that would be a good process.

Commissioner WALDRON. That would be fine. I would also ask you to think about any other ways that the provisions of the WTO can be used against—and I stress here "against"—the U.S. and other countries, because based on my own study of Chinese negotiating approaches and all the rest, the reason why they join an international regime usually has very little to do with what they want to do inside China and has a great deal to do with what they want to make other countries do. In this, they are very excellent strategists and legal tacticians, and they will very often employ very small points, small legal points, in ways that enable them, as it were, to disassemble whole sections of an international agreement in a way that generally catches, frankly, people like the four of you on the panel and many of us here completely by surprise.

I don't want to bore you with examples, but I want you to really think this one out—in other words, as they would say in Chinese, to "turn the spear point" of WTO toward the United States, because we are all portraying it—the U.S. business lobbies, the various people in the Government and so forth have all been portraying this as a means by which we are going to pressure China. Now, if it really is a means by which we are going to pressure China and cause them to do things that they don't want to do, why are they so eager to join it?

Co-Chairman MULLOY. Anyway, thank you.

Now, I have one question. First, I was very delighted about two points. One, I think the WTO process, as you pointed out, Ambassador Bader, is going to take a long time to get these individual—so I think that bilateral mechanisms to try to sort out some of these things are very important.

Second, I was delighted to hear Secretary Lash talk about that he has consulted with Japan and the EU, because I think we can't just be the big "nanny" ourselves; we have got to have other people working with us in picking out the priority issues that we should all work to get China to live up to.

There is an other issue that I want to ask a specific question on. When I was up here on the Hill, one of the key issues that people would be worried about was when Boeing would make a sale of airplanes to China, they would end up moving some of the production and jobs to China. We used to call that "technology transfer." Some people call it "forced technology transfer"—in order to make the sale, you had to do the other.

My understanding is that there are provisions in the WTO agreement. The question is who do they bind. Do they bind just the government? Do they bind state-owned enterprises? And secondly, how do you enforce such agreements?

If I could turn to both Secretary Lash and then Ambassador Bader to deal with that issue, I would find it very helpful.

Mr. BADER. Mr. Commissioner, you are absolutely right; there are specific provisions about that in the Working Party report having to do with TRIMs, trade-related investment measures, and with offsets, required FOREX balancing—all of these practices that China traditionally used, all of which they cannot use in the future according to the WTO agreement.

I'll leave aside for a moment the question of enforcement—well, just one comment on the issue of enforcement. If there are previous contracts that require FOREX balancing or export performance, they are not enforceable in Chinese courts. We are talking about not only future contracts but past contracts; they are not enforceable under the WTO.

So again, what we have here is a standard. If the Chinese fail to meet that standard, we have to look at all the mechanisms we have, up to and including dispute settlement, to challenge them.

Mr. LASH. I agree with Jeff 100 percent on that. At the same time, I think the real challenge, Mr. Chairman, is reaching out to our companies to make sure our companies know that these practices are not required and to make sure that our companies know that they are not obligated to make these transfers, and to make sure they know that the Government's method will step in to protect them and negotiate on their behalf on those narrow points. Again, if there is a WTO-inconsistent provision that is being laid out as a contract provision, it is important that companies know they are not negotiating by themselves.

Mr. BADER. I'm sorry, Mr. Chairman, if I could go back just briefly, I just remember one other critical point on this. One of the most difficult aspects of the end game on negotiation was precisely on trading rights, where there was a certain ambiguity on the Chinese commitment to assure that companies could export to China without some form of registration or investment presence in China, and that was something that we nailed down, frankly, in Shanghai last year. It is unambiguous that companies have the right to export to China without having an investment presence.

Co-Chairman MULLOY. Just as a means of monitoring this, it may be helpful—because I think the companies will be reluctant to come in and say they are being pressured to do this—but there has to be some way of following this, because I think you cannot expect the companies to be the ones that are going to necessarily report it.

I want to tell you how helpful this panel has been to the Commission, and I want to thank you all for your testimony. We will want to work closely with you folks as we are putting together our report to Congress, so if there are things that you think we should be recommending, or suggestions, I think it will be important for us to stay in touch and get your ideas as we proceed to write the report.

Before we finish up, I want to turn to Chairman D'Amato for a brief comment.

Chairman D'AMATO. I would just like to make one final comment. First, I want to thank you for your testimony, and we do want to stay in touch with you and appreciate your coming. We know your time is valuable.

We have been talking about compliance by the Chinese with the rule of law, with WTO, and openness, so it was disturbing when it was reported to me two days ago by officials of the American Chamber in Beijing that they were not able to access our website. We think that that kind of openness in terms of this Commission would be useful on the part of the Chinese, and quite candidly, on visits that we have made to China, the Commission has had some difficulty arranging those visits, I think unnecessarily.

So we think that, obviously, the attitude of the Chinese toward openness, toward the Congress and to our Congressional bodies is very important here. So if you would carry that message back to your counterparts, we would very much appreciate that.

Co-Chairman MULLOY. Let me just add that once we did get in, I think we got access, and we had very good meetings; but I think the initial effort——

Chairman D'AMATO. The gatekeepers are tall.

Co-Chairman MULLOY. Yes.

Thank you all very much.

We'll take a 5-minute break.

PANEL II: WTO COMMITMENTS AND COMPLIANCE

Co-Chairman MULLOY. As I noted earlier, in this morning's session, we are focusing on China's WTO commitments and how we might enforce them. We have heard from the Government panel, and now, we are very fortunate to have a very distinguished group of people from outside Government who will offer their perspectives on this issue.

Among them is Professor Donald Clarke of the University of Washington Law School, and we greatly appreciate your being here on short notice. A very distinguished professor, Jerome Cohen, was going to do it, and something came up that prohibited it, and he did testify before this Commission last June. So we are delighted to have Professor Clarke on short notice.

Mr. CLARKE. Thank you. I am happy to be here.

Co-Chairman MULLOY. The second panelist is Professor Margaret Pearson of the University of Maryland. She served on a special task force put together by the Council on Foreign Relations on China's WTO accession.

We also have Mr. Jeff Fiedler, who is a consultant to the Food and Allied Services Trade Department of the AFL–CIO, who also served on that Council on Foreign Relations task force, and I understand dissented from the overall recommendations of that task force, so we will be very interested to hear from him.

Then, we have Mr. Terence Stewart, whose law firm, Stewart and Stewart, is preparing a study for this Commission that will help set benchmarks that will help future efforts to monitor and assess China's WTO compliance effort.

And finally, we have Mr. Dan Brody, who is Executive Director of the U.S. Information Technology Office in Beijing, who has come from Beijing to be here today.

Mr. Brody had a chance to meet with Commissioners during a breakfast meeting, so his testimony here will be abbreviated, but we did want to have him available to field questions, because I know that different commissioners had follow-up questions for Mr. Brody.

So if I could start with Professor Clarke, then we'll move across to the left.

STATEMENT OF DONALD C. CLARKE, PROFESSOR OF LAW, UNIVERSITY OF WASHINGTON SCHOOL OF LAW

Mr. CLARKE. Thank you, Mr. Chairman.

I understand, actually, that all of our testimony today is to be abbreviated to 7 minutes; is that right?

Co-Chairman MULLOY. That's correct, and please follow these lights. When it is yellow, it means sum up, and when it is red, you should try to finish up.

Mr. CLARKE. All right. Thank you very much, Mr. Chairman and members of the Commission. I hope that I can be something of a substitute for Jerry Cohen, although those of you who have met Jerry will know that it is very difficult to match his thunder.

I have been asked to address several issues of China's ability to comply with its WTO commitments, particularly with respect to aspects of its legal system, and also to discuss how the U.S. might work bilaterally with China to help facilitate compliance. So here, given that I have only 7 minutes, I am just going to be able to hit on a few of the key points of the written statement that I submitted.

The first thing to note is that China has quite a massive task to undertake in making its laws and regulations conform to the WTO—perhaps larger than just about any other country at the time that it became a member.

On the other hand, there is a big difference between China and other countries that have become WTO members, I think, and that is that China's accession is just one part of a much larger strategy of economic reform, and consequently, many—not all, of course, but many—of China's WTO commitments while called "concessions" in the language of international trade, are not necessarily properly viewed as concessions that China had to give up in order to get something else it wanted. In many cases, these are measures that the government would have wanted to take for their own sake, whether or not China had gone into the WTO.

So, like other reform measures, they of course do face some domestic opposition in China, and some of them are controversial, but on the other hand, it is important to recognize that for many of these measures, there is also a strong domestic constituency in favor of them.

Just looking at China's ability to comply, looking backward, there has been as I mentioned very, very large and intensive effort to weed through China's existing laws and regulations to try to figure out which ones are WTO-compliant and which ones are not, and this has involved literally thousands, perhaps many, many thousands, of regulations.

I am a bit skeptical of whether this effort can actually have the desired goal, simply because it is difficult in many cases to tell in the abstract whether a regulation violates WTO commitments. One has to have a specific controversy before one can figure this out, but nevertheless there has certainly been an effort there. There have been many training sessions for officials, and some restructuring of the government to meet WTO commitments has begun.

Looking forward, again, because of the link between WTO commitments and domestic economic reform, although one cannot predict the future, I do see the potential for substantial compliance in many of these commitments as long as economic reform continues. So that, for example, some of the market opening commitments are things that I think the Chinese Government has come to recognize make sense for China, regardless of whether they are required by the WTO or not.

But of course, problem areas will exist, and we need to distinguish some of the important ones from the transient ones.

Looking at particular problem areas related to the legal system, one bit of underbrush I want to clear away first is that there is some discussion that I have seen about whether WTO obligations are directly applicable within the Chinese system. In other words, do WTO obligations become part of the Chinese domestic legal system upon China having properly ratified its accession? And the answer to that is no; China's domestic legal system in this respect is much like the U.S. domestic legal system. In other words, there needs to be specific legislation passed by appropriate Chinese governmental bodies before WTO obligations become part of the Chinese legal system.

Another question that came up during the negotiations—and this is clear from the Working Party report—is the issue of the authority of subnational governments. If a provincial government or a local or municipal government establishes some kind of noncompliant trade barrier—and there are many domestic trade barriers within China, I should add—what is the obligation of the central government with respect to these trade barriers?

Article 24 of the GATT says that national governments have an obligation to take reasonable measures to ensure that subnational governments comply. Is that all China is obligated to do? And I think that here, the answer is no. China is not a federal system. Local governments do not under China's formal constitutional system have the power to oppose the central government; they cannot do what the central government forbids, and they must do what the central government commands, and for that reason, Article 24 is not really applicable. China does have an international law obligation to ensure that local governments comply, not merely to take reasonable steps.

On the other hand, as we probably all know, local governments do enjoy in many areas a substantial de facto autonomy from the central government, so there will be problems. But it is important to recognize that in many of these cases, I think the interests of the central government are actually going to be allied with the interests of other WTO members in the sense that the central government has an interest in trying to reduce the powers of local government to establish these local trade barriers, because this is a substantial barrier to commerce within China as well as simply a barrier to commerce between China and its trading partners.

The other issue that, given the limited time, I might address is the ability of courts to handle complex cases. This is not always going go be an issue, because many cases that come before courts do not implicate the WTO, of course, and the WTO does not require a perfect or even a good legal system across the board. But there are still very many problems with judges; I would suppose that only 10 percent have a 4-year college degree in law. The courts are unreliable as enforcers of rights. There are corruption problems, there are problems with the enforcement of judgments, and in many cases, courts simply don't want to take on difficult and possibly controversial cases. They do not formally send the plaintiff back with a loss; they just say, "We are not going to handle this case."

And finally, perhaps the most problematic for WTO purposes is that it is probably still too soon to expect courts to provide reliable independent review of administrative action. The courts are still too dependent on government in general and on local government in particular, and within the Chinese system, it does not really make sense that low-status officials from a low-status organization like courts would be able to give orders to high-status officials from powerful government organizations.

I see my time is up; the red light is flashing, so I will have to stop.

[The statement follows:]

PREPARED STATEMENT OF DONALD C. CLARKE

Mr. Chairman and Members of the Commission, I am very pleased to have the opportunity to address the Commission today on issues of China's accession to the WTO. I have been involved in Chinese studies in one way or another since the early 1970s and have been interested in Chinese law for over 20 years. I have taught the subject since 1985, first at the University of London and now at the University of Washington, and have also spent time in practice advising companies doing business in China.

I have been asked to address several aspects of China's membership in the WTO, in particular China's ability to comply with certain of its WTO commitments from the standpoint of its legal system. I have also been asked for recommendations on ways the United States might be able to work bilaterally with the Chinese to help facilitate their compliance with the WTO, including mechanisms to resolve problems short of the formal WTO dispute settlement process.

Background

It is well understood both inside and outside of China that the task of making China's laws and regulations conform to WTO requirements is a huge one. But a key feature of China's accession to the WTO that sets it apart from most other countries is not the size of the task, but the fact that accession is part of a larger strategy of massive and fundamental economic reform. The Chinese government has embarked on this strategy for its own sake, not to fulfill treaty commitments to foreigners, and Chinese leaders have sought WTO membership not simply because they believe that it will open more markets to Chinese products, but because they see membership as giving them extra leverage to force through difficult changes in the domestic economic system. Many in the leadership understand that China's WTO commitments, while labeled "concessions" in the language of international trade negotiations, are not really "concessions" to be reluctantly yielded at all, but rather sound policies that China would be wise to adopt even without WTO membership. Reforms simply imposed from outside are unlikely to go beyond surface compliance—if they get even that far—and truly take root. But many of the reforms required by China's WTO accession, from market opening to greater transparency in administrative procedures, have a strong domestic constituency as well as a foreign one. The influential "Legal System Daily," for example, last November published no fewer than three commentaries by prominent law professors welcoming the pressures that WTO membership would impose in the direction of limited government and increased transparency.[1] Thus, although China's trading partners may encounter rules and practices inconsistent with China's commitments and delays in curing these inconsistencies, it is not necessarily due to bad faith and foot-dragging by the central government (although of course that is a possibility). In many cases it will be due simply to the normal and well-documented difficulty the central government faces in getting many things done.

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[1] See Yuan Chengben, "Ru Shi wei sifa gaige tian dongli" (Joining the WTO Pushes Forward Judicial Reform), *Fazhi Ribao* (Legal System Daily), Internet edition, Nov. 30, 2001 (interviewing Professor Li Shuguang); Ma Huaide, "WTO yu zhengfu zhizheng linian" (The WTO and the Guiding Concept of Government), *Fazhi Ribao* (Legal System Daily), Internet edition, Nov. 26, 2001; Wang Feng "'Ru Shi'yaoqiu zhengfu juese zhuanbian" (Entry into the WTO Requires a Change in the Role of Government), *Fazhi Ribao* (Legal System Daily), Internet edition, Nov. 12, 2001; see also Nan Xianghong, "WTO: fa de chongxin goujia" (WTO: The Restructuring of Law), *Nanfang Zhoumo* (Southern Weekend), Internet edition, Oct. 25, 2001; and Guo Guosong, "Wei sifa gongzheng jianli zhidu bingzhang" (Establish Institutional Protections for Judicial Justice), *Nanfang Zhoumo* (Southern Weekend), Internet edition, Oct. 25, 2001 (addressing the need for better court procedures, from improving the quality of judges to achieving greater transparency). For Chinese language sources, I have placed the author's surname before the given name in accordance with Chinese usage.

This is by no means a counsel of inaction and infinite patience in the face of a failure by China to live up to its commitments in certain areas. As I have noted, part of the whole point of joining the WTO—a central government decision essentially imposed on local governments—was to add foreign pressure to existing domestic pressures for reform. It does nobody any favors to pretend that specific and binding obligations do not exist. But it is necessary to bear in mind that not all violations will be deliberate, and that not all delay is obstruction.

China's Ability to Comply with WTO Commitments and Procedures

This section will look at China's ability to comply with WTO commitments and procedures with respect to its legal system in general, my particular area of expertise. I will not be attempting to predict whether China will indeed fulfill its commitments regarding, say, customs valuation procedures (see Para. 143 of the Working Party Report).

In assessing China's ability to fulfill its commitments and to comply with WTO procedures in such matters as the Transitional Review Mechanism and dispute resolution, we need both to look backward and to look forward. Looking back, one cannot fail to be impressed by the amount of work that has been done so far in identifying, and revising or abolishing where necessary, laws and regulations inconsistent with China's WTO obligations.[2] This work began, of course, long before China's formal accession last November. The scope of the effort can be appreciated by seeing what the Ministry of Foreign Trade and Economic Cooperation is reported to have achieved by the end of 2000, over a year ago, in anticipation of WTO membership: the review of over 1,400 laws, regulations, and similar documents, including six statutes (of which five were revised), 164 State Council regulations (of which 114 were to be repealed and 25 amended), 887 of its own ministry regulations (of which 459 were to be repealed and 95 amended), 191 bilateral trade agreements, 72 bilateral investment treaties, and 93 tax treaties.[3] In the first two months of the year 2001, the various ministries and commissions of the State Council are reported to have reviewed some 2,300 laws and regulations, of which 830 were identified as in need of repeal and 325 as in need of revision.[4]

Indeed, one might almost say that the Chinese officials and commentators are afflicted by too strong a sense of urgency. It is commonly said, for example, that the need to identify and revise inconsistent regulations is pressing because if inconsistencies are found once China is in the WTO, its trading partners can impose trade sanctions. In fact, of course, the process is not nearly so fast. The complaining state would first have to notify China of its complaint and enter into discussions with it; only if it were dissatisfied with the results might it bring a proceeding under the WTO's dispute settlement procedures, and if China ultimately lost it would then still have a reasonable time (Article 21.1(c) of the Dispute Settlement Understanding suggests 15 months as a general guideline) within which to modify the offending regulations.

Needless to say, the process of trying to identify inconsistent regulations in the abstract is bound to miss many problem areas. Identifying inconsistency is sometimes easy, but at other times takes a high level of expertise and a full hearing by a dispute settlement panel in the context of a particular set of facts. Thus, we should not be surprised if many inconsistencies remain despite the government's efforts. Nevertheless, I believe that the government has so far shown a great deal of energy in addressing problems of legislative inconsistency.

Outside of the field of legislative revision there has also been a great deal of activity. The last several months have seen a flood of new regulations designed to implement China's commitments. There have also been countless training sessions for Chinese officials, many with foreign financial support.[5] The government has begun restructuring to facilitate the meeting of WTO requirements. For example, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) has established a Department of WTO Affairs to handle implementation and litigation as well as to serve as the central place for bringing inquiries and responding to complaints. It has also

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[2] As this statement is intended to be largely forward-looking, it is not the place to canvass in detail what China has already accomplished in terms of WTO implementation. The United States-China Business Council has compiled useful summaries that can be found at <www.uschina.org/prcwtocompliance.pdf> (dated June 2001) and on page 14 of the January-February 2002 issue of the *China Business Review* (dated September 2001).

[3] Nan Xianghong, "WTO: fa de chongxin goujia" (WTO: The Restructuring of Law), *Nanfang Zhoumo* (Southern Weekend), Oct. 25, 2001.

[4] *Id.*

[5] A partial, but nevertheless very long, list of such programs can be found in the Brian L. Goldstein & Stephen J. Anderson, "Foreign Contributions to China's WTO Capacity Building," *China Business Review*, vol. 29, no. 1 (Jan.–Feb. 2002), pp. 10–11.

established a body to handle WTO notifications and a Fair Trade Bureau for Import and Export to handle issues relating to unfair trade practices.[6]

While much work remains to be done, then, there can be little doubt of the energy and commitment shown so far by the government. And this is to say nothing of the enthusiasm for knowledge about the WTO displayed outside of government. Almost any lecture or presentation with the word "WTO" in it is guaranteed to draw a large audience, and indeed among urban Chinese the English abbreviation is probably as common as, if not more common than, the original (and shorter) Chinese abbreviation (*shi mao*).

Looking forward, I am generally sanguine about the prospect of China's compliance with its commitments and its willingness and ability to modify its rules if it loses a WTO dispute settlement proceeding. But there will be disappointments, and it is necessary to understand and anticipate them in order to put them in proper perspective and distinguish real and pressing problems from temporary and minor ones.

One issue that should be clarified at the outset is that of the direct applicability of China's WTO obligations within its domestic legal system. To summarize briefly, China's WTO obligations will not become part of its domestic law, binding on courts and government bodies, until appropriate domestic legislation and regulations incorporating those obligations are promulgated. Although there has been some commentary suggesting the contrary,[7] the dominant view—and the view that counts for practical purposes—is that specific incorporation into domestic legislation is necessary.[8] This view is certainly the one China presented in the meetings of the WTO Working Party. In Para. 67 of the Working Party Report, for example, China undertakes to meet its WTO commitments "through revising its existing laws and enacting new ones fully in compliance with the WTO Agreement."

The extent to which China revises its existing laws and promulgates new ones is something that can be monitored with relative ease. But clearly it is not enough simply to promulgate new regulations. They must be applied and enforced. Here, there are at least two major issues worthy of discussion.

The first is the extent to which local governments will engage in WTO-inconsistent practices that the central government is unable or unwilling to stop. We should be clear about one thing: there is no question that, as a legal matter under China's constitutional system, local governments may not do what the central government forbids them to do, and must do what the central government requires them to do. Because the central government has the legal capacity to require local governments to conform to WTO obligations, it has the obligation to do so.

Some members of the WTO Working Party on China's accession were reported to have expressed concern that subnational governments in China might take measures inconsistent with China's WTO obligations, and that the central government would not or could not remove such measures. The representative of China assured them (see Para. 70 of the Working Party Report) that local governments had no autonomous authority over trade-related matters, and that the central government would "ensure" (not merely take the "reasonable measures" called for by Art. XXIV:12 of GATT 1994) that local government regulations conformed to China's WTO obligations. This assurance is one of China's formal commitments. Art. XXIV:12 of the GATT 1994, which presupposes a degree of independence on the part of local governments, simply does not apply.

Obviously, however, the real question is not quite so simple as the legal question. Subnational governments in China can enjoy considerable *de facto* autonomy from Beijing; this is a fact, not simply a convenient excuse for inaction cooked up by the

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[6] See Xianwu Zeng, "Trading Rights After China's WTO Entry," *China Business Review*, vol. 29, no. 1 (Jan.–Feb. 2002), p. 19.

[7] See, for example, Tieya Wang, "The Status of Treaties in the Chinese Legal System," *Journal of Chinese and Comparative Law*, vol. 1, no. 1 (July 1995), pp. 1–18, and Meng Xianggang, "Woguo shiyong WTO guoji guize de liang wenti" (Two Issues in the Application in China of the International Rules of the WTO), *Renmin Fayuan Bao* (People's Court News), Internet edition, March 29, 2001. Both authors support their argument by noting the existence of some (by no means all) statutes providing that where the provisions of the statute conflict with China's international treaty obligations, China's international treaty obligations shall override the provisions of the statute. But surely this shows precisely that a specific rule in a domestic statute is necessary to give domestic legal effect to a treaty obligation; the very fact that the rule needs to be stated in a domestic statute contradicts their position.

[8] See, for example, Zhaojie Li, "The Effect of Treaties in the Municipal Law of the People's Republic of China: Practice and Problems," Asian Yearbook of International Law, vol. 4 (London: Kluwer Law International, 1994), and more recently (and perhaps more authoritatively, as the author is a member of the administrative law chamber of the Supreme People's Court), Kong Xiangjun, "WTO falü de guonei shiyong" (The Domestic Application of WTO Law), *Fazhi Ribao* (Legal System Daily), Internet edition, Dec. 16, 2001.

Chinese central government. China suffers from numerous internal trade barriers that the central government is continually struggling, often unsuccessfully, to remove. We should not be surprised if, with the best will in the world, it has at least as much difficulty removing barriers to foreign goods and services.

The phenomenon of local protectionism is one that has attracted the attention and concern of academics and policymakers in China for some time. Internal trade barriers are just one aspect of it; favoritism to local parties in courts is another. But it is important to understand that it is not just foreigners who want to get rid of it. It is generally in the interest of the central government to expand its own sphere of actual authority and to reduce such local protectionism, and it is more practical considerations than ideological ones that have stood in the way of progress in this area. It has been proposed for years, for example, that judges in local courts should be appointed and salaried by the central government instead of the local government. So far, however, the central government has not been willing to expend the political and financial resources necessary to put this reform into practice. But pressure for such reform is building, as shown by the recent appearance in *Jingji Yaocan*, the internal (non-public) journal of the State Council's think tank on development issues, of an article advocating precisely such a reform.[9]

The main factor behind local economic protectionism is the dependence of local government upon local enterprises for revenues. To the extent a government takes revenues, whether in the form of taxes or profits, from an enterprise, it is of course not unlike an owner and has the same interest in protecting those revenues. When the owner of an enterprise can control the conditions under which that enterprise competes, the results are utterly predictable. With the further progress of economic reform in China, one might expect to see a widening of the tax base and a reduction of the dependence of local governments upon specific enterprises for revenues. Needless to say, however, the influence of powerful local businesses seeking protection will not disappear in China any more than it has disappeared in China's trading partners.

The second issue I wish to raise here is that of the capacity of China's courts to handle a substantial workload of reasonably complex cases. Here the news is neither especially good nor especially news, since it has been widely known for some time that China's courts are weak and its judges, on the whole, poorly qualified. China's courts will continue to present difficulties in the years ahead. On the other hand, as in many other areas of Chinese legal and political life, we can expect the most reform in areas where there is a solid domestic constituency for it, and court reform is undoubtedly one of those areas. The key issues in court reform from the standpoint of China's fellow WTO members are the qualifications of judges, the willingness and capacity of courts to render fair judgments free of corruption and pressure from local government, and the ability of courts to execute those judgments once rendered.

The low qualifications of China's judges are no secret, and indeed are a regular subject of discussion by high government officials, including the President of the Supreme People's Court.[10] As of 1995, for example, only five percent of China's judges nationwide had a four-year college degree in any subject (let alone in law),[11] and it is currently estimated that about 10% of judges have four-year college degrees in law.[12] A 1998 study of nine basic-level courts (the lowest level) in a major provincial city revealed that only three percent of the judges had a bachelor's degree in law and that the "great majority" had had other types of jobs in the court administration such as bailiff, clerk, or driver before being promoted to the rank of judge.[13]

The frequency with which situations such as this are reported suggests strongly that there is no political difficulty with advocating reform and that such advocacy is supported in important sectors of the central government. China has in fact recently taken solid steps toward improving the qualifications of judges. This March, for example, will see the first administration of a new unified judicial examination

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9 See Wang Xu, "Tuijin sifa tizhi gaige, ezhi sifaquan difanghua qingxiang" (Push Forward Reform of the Judicial System, Block the Trend Toward Localization of Judicial Power), *Jingji Yaocan* (Economic Reference), no. 74, 2001 (Nov. 31), pp. 11–22.

10 See the remarks of Xiao Yang reported in "Xiao Yang zai renmin fayuan 'ru shi'hou shenpan gongzuo huiyi shang tichu zhuanbian sifa guannian tigong sifa baozhang" (Xiao Yang Proposes to Change Judicial Concepts, Supply Judicial Guarantees at Conference on Adjudication Work of People's Courts Following WTO Accession), *Fazhi Ribao* (Legal System Daily), Internet edition, Nov. 21, 2001.

11 See Deng Ke, "Sifa gaige: xianshi yu keneng" (Judicial Reform: Reality and Possibilities), *Nanfang Zhoumo* (Southern Weekend), Internet edition, Oct. 25, 2001.

12 Author's interview with members of Beijing University Faculty of Law, March 2001.

13 See Li Xiaobin, "Shenpan xiaolü ruhe neng you da fudu tigao" (How Can There Be a Large Increase in the Efficiency of Adjudication?), *Faxue* (Jurisprudence), no. 10, 1998, pp. 52–54.

for lawyers, prosecutors, and judges. Although sitting judges will not be required to take or pass the examination, to require this of judges going forward is already a very far-reaching (indeed, surprisingly so) reform at this stage of China's legal development—so far-reaching, indeed, that one wonders whether the pool of those who pass and are willing to serve as judges will be big enough to serve the needs of the court system. In any case, however, this reform—and the political difficulties that must have been overcome to effect it—is solid evidence of the potential for significant reform to occur where there is a domestic constituency for it. Fortunately, there *is* a domestic constituency for significant further reforms in the judicial system.

In addition to the problem of the quality of judges, China's courts are at present not fully reliable as enforcers of statutorily guaranteed rights. This is true for a number of reasons. First, while statutes are superior to regulations issued by government ministries in China's formal constitutional structure, a ministry regulation that is directly on point will generally be considered in fact to be directly applicable rule by both government officials and court officials. This is simply a matter of what might be called customary legal culture; it has been both noted and criticized in China as well as abroad,[14] and among many critics WTO accession was viewed as a helpful spur to change. Nevertheless, change will not come quickly. Second, there is the well known problem of corruption in the judiciary. This problem is not of course unique to China. Third, Chinese courts often have difficulty enforcing their judgments. As this problem is also well known and has been the subject of considerable commentary elsewhere by myself and others,[15] I will not go further into it here.

Fourth, and less well known, is the tendency of Chinese courts not to aggressively seek jurisdiction over cases, but on the contrary to fear it and often go to great lengths to avoid taking difficult or sensitive cases. Courts in China have the choice of accepting or not accepting a case. This is somewhat akin to summary judgment in its gatekeeping function, but very much unlike it in that it is not governed by any consistent set of principles other than the court's general sense of whether the case seems meritorious and deserving of further proceedings. Courts can use this power simply to decline to hear, and thus avoid ruling on the merits of, cases that look troublesome and likely to cause serious offense to powerful interests no matter how the court decides.

Most recently, the Supreme People's Court of China stirred up a major controversy when it instructed lower courts simply to stop accepting shareholder suits for damages based on certain violations of China's Securities Law.[16] This instruction, it is important to note, was not based upon a theory that the shareholders had no legal right of action under the Securities Law. It was explicitly based on the grounds that adequate procedures had not yet been worked out for hearing such suits, and that they would therefore have to wait.[17] The real reason was simply that the courts were terrified of a number of looming actions in which shareholders were bringing, or about to bring, suit in several courts around the country, and the specter of overloaded judicial resources and inconsistent decisions on similar facts was too much to contemplate.

Just this week, on January 15, the Supreme People's Court finally announced that investors would be allowed to proceed with actions based on claims of false disclosures in securities trading, but only where China's Securities Regulatory Commission had established the existence of such false disclosures.[18] While this is no doubt welcome news to investors, it underscores the casual attitude toward statutorily granted rights taken not only by government agencies, but by the courts themselves. The Court apparently agrees with the plaintiffs that they state a valid claim under the Securities Law, but has interposed, without any statutory foundation whatsoever, the CSRC as a gatekeeper in order to ensure that claims not approved by the

[14] See, for example, my "State Council Notice Nullifies Statutory Rights of Creditors," *East Asian Executive Reports*, vol. 19, no. 4 (April 15, 1997), pp. 9–15.

[15] See Randall Peerenboom, "Seek Truth from Facts: An Empirical Study of the Enforcement of Arbitral Awards in the People's Republic of China," *American Journal of Comparative Law*, vol. 49, no. 2 (2001), pp. 249–327, and my "Power and Politics in the Chinese Court System: The Execution of Civil Judgments," *Columbia Journal of Asian Law*, vol. 10, no. 1 (Spring 1996), pp. 1–125.

[16] See Supreme People's Court, "Guanyu she zhengquan minshi peichang anjian zan bu shouli de tongzhi" (Notice on Temporarily Not Accepting Securities Cases Involving Civil Suits for Damages), Sept. 21, 2001.

[17] See "Gao yuan biaoshi shenli zhengquan jiufen an jiang zhubu tuikai" (Supreme Court Indicates that the Hearing of Cases Involving Securities Disputes Will Gradually Be Increased), *Zhongguo Zhengquan Wang* (China Securities Net), Internet edition (www.cnstock.com), Oct. 11, 2001 (reporting remarks of Supreme People's Court official Cao Shouye).

[18] See Richard McGregor, "China to Allow Investors to Sue Listed Companies," *Financial Times*, Internet edition, Jan. 15, 2002.

government will not come before the courts. (And all other claims remain barred for at least the time being.)

Despite these problems, it must be recalled that the WTO does not mandate a perfect legal system, or even a basically fair one, outside of a few specific areas. Such a system would be welcomed by many in China, and many hope that WTO membership will promote its achievement, but the WTO does not actually require it except with respect to intellectual property under TRIPS.

In TRIPS, there are a number of requirements set out for fair judicial proceedings for the protection of intellectual property rights, but even here there are also a number of clauses specifying that these commitments are not to be read as obligating members to make drastic changes to their judicial system. The list of requirements set forth in Article 41–50 of TRIPS could in fact be read as a list of things a country's judicial system does *not* need to have outside of this particular realm.

Both the GATT (Art. X) and the GATS (Art. VI) have requirements of their own regarding transparency and the impartial administration of law, but these apply only to a particular subset of laws: those regulating trade in goods and scheduled services. There is no requirement of a fair legal system and the uniform and impartial administration of laws in any other respect.

Of course, it is unlikely that any country could or should maintain a legal system that was capable of delivering fairness in one sector and unable or unwilling to do so in others. Nevertheless, it is important to bear in mind that the undoubted problems of China's legal system cannot uniformly be condemned as violations of its WTO commitments.

The area of the Chinese legal system that will probably cause the most difficulty is its present inability to provide, at least on a consistent basis, truly independent review of administrative actions. The financial dependence of courts on local government is compounded first by the lower political status of judges relative to many of the officials whose actions they will be called upon to judge, and second simply by the tradition of judicial deference to administration. This tradition is reinforced in a very concrete way by the structure of courts, which are at every level part of the so-called "political-legal" system at the same level, a vehicle of Party control that coordinates the activities of courts, police, and prosecutors. Parties may be justly dubious of receiving an impartial hearing in an environment where *ex parte* contacts are common, corruption is widespread, and courts are allowed and even encouraged to contact superior courts (without notice to the parties) for their advice on specific cases before rendering a judgment.

Future reform is not, of course, out of the question. As I have noted earlier, the problems were diagnosed in China long ago and the solutions to at least some of them are there on the table: among them, for example, putting power over staffing and financing of courts to the central government, raising judicial salaries in order to attract a higher calibre of personnel, and ending the use of courts as a dumping ground for demobilized army officers.

Bearing in mind the problems outlined above, I shall now turn to a few specific commitments relating to China's legal system (I am not addressing here any of China's commitments respecting specific trade matters such as tariff levels, quotas, etc.) where I see potential difficulties in compliance. Three relate to transparency. In Para. 334 of the Working Party Report, China promised to make available in one or more of the official WTO languages all laws, regulations, and other measures pertaining to or affecting trade in goods or services, TRIPS, or foreign exchange control not less than 90 days following their implementation. When one realizes the scope of regulations and issuing bodies that is involved, this is a huge commitment. It is worth noting that despite the great thirst in the private sector for such translations, not a single service, commercial or otherwise, exists today that can truly say that it provides translations of *all* such laws and regulations. The universe is simply too vast.

China has undertaken a similarly vast commitment in Para. 336 of the Working Party Report. It has promised to designate one or more enquiry points where information about all laws, regulations, and other measures pertaining to or affecting trade in goods or services, TRIPS, or foreign exchange control, as well as texts, can be obtained. To fulfill this promise completely, the enquiry point will have to be fully informed as to all relevant provincial and local regulations from all parts of China. One wonders whether any country could carry this out successfully.

Finally, in Para. I.2.C.3 of the Accession Protocol, China has promised that any individual, enterprise, or WTO member can get information about any measure required to be published under the Accession Protocol at a designated enquiry point, and that a response must be forthcoming within 30 or at most 45 days. Although China has promised an "authoritative" reply only to fellow WTO members, it has nevertheless promised an "accurate and reliable" reply to individuals and enterprises. Even this standard could prove difficult to meet if the enquiry point is flooded with questions. In short, these three provisions all seem to promise to make available a kind of knowledge that does not currently exist, and which it will be very burdensome to provide.

Similar problems are likely to afflict the Transitional Review Mechanism, which on China's part consists primarily of the obligation to supply information. It seems inevitable that China will interpret the requirements for information narrowly, given the vast range of information called for. While procuring the statistical information called for is merely a question of requiring the relevant authorities to collect it, it will be more difficult to provide the complete lists of relevant regulations and administrative measures that are called for, since it will not always be obvious that a particular regulation may have an impact on, for example, trade in goods or services.

In addition to the specific problems indicated above, the Working Party Report and the Accession Protocol also pose somewhat contradictory demands both at the conceptual level and at the concrete level. They generally promote the strengthening of legal institutions in China, but in some places seem to promote the opposite and to encourage China to continue its tradition of administrative omnipotence. More generally, China's government is paradoxically being asked to exercise central power to further decentralization, and to exercise administrative power to strengthen judicial power.

Consider, for example, Para. 68 of the Working Party Report: China promised that administrative regulations, departmental rules and other central government measures would be implemented in a timely manner, and that if they were not changed in time, the government would still honor China's WTO commitments. Presumably China made this promise at the behest of the members of the Working Party, but it is tantamount to saying that the government may decide at any time simply to ignore its own duly promulgated regulations and to operate according to some other set of standards. Fortunately for the rule of law in China, the Chinese government was apparently not asked to promise to ignore "laws," *i.e.*, legal requirements issued by a constitutionally superior body, the National People's Congress or its Standing Committee.

Perhaps more troublesome is the fact that apparently not only is the government to ignore its own regulations if they cannot be changed in time, but so also are the courts. Here, the issue is how courts are to be notified, other than through the normal process of formal repeal and replacement, that duly promulgated State Council regulations they would normally be bound to implement have lost their effectiveness. The only method would seem to be one that China's trading partners are in other arenas encouraging her to move away from: the unofficial note or telephone call from a senior official instructing courts how to operate in a way that is both arbitrary and opaque.

Similarly, Para. 203 of the Working Party Report contains a promise not to enforce the terms of contracts containing foreign exchange balancing, local content, or export requirements. The demise of such obligations will cause few tears among foreign investors. If the government is saying that as a regulator, it will decline to exercise its discretionary authority to seek sanctions against those who do not fulfill those terms of their joint venture contracts, that is one thing. But if it is claiming the power to order courts not to enforce, between parties, contract rights arising under laws passed by the National People's Congress or its Standing Committee (both constitutionally superior bodies), that is quite another. It may indeed have such power as a matter of fact, but whether China's trading partners should be encouraging its exercise is questionable.

Potential U.S. Assistance with Compliance and Capacity-Building

I would like to end with a few words on potential United States assistance with compliance and capacity-building. Because of China's relative lack of experience with a market economy, it is inevitable that despite the government's efforts to identify and weed out WTO-inconsistent legislation, some inconsistent rules and practices will remain, and new ones will crop up. It is in fact likely that many such inconsistent rules will be discovered over time. As I have discussed, the government has already devoted considerable energy to making Chinese laws and regulations consistent with its WTO obligations. As in any country, there may be rules the government wishes to retain that its trading partners view as questionable under WTO principles, like the E.U.'s rules on bananas or the U.S. rules on Foreign Sales Corporations. And there may be rules that displease China's trading partners that do not in fact run afoul of the WTO agreements. But there is no reason to doubt that the government is in principle genuinely committed to getting rid of many of the old rules that shackled the economy and has seized WTO accession as an opportune moment to do it. There is no reason to think that the Chinese government is committed to defending every WTO-inconsistent rule to the bitter end.

As the Commission will probably be hearing from other witnesses, the U.S. is now very much involved, both at the governmental and the non-governmental level, in activities aimed at promoting compliance and building capacity. These activities should continue. Considering the volume of trade at stake, the required expenditure is probably quite modest.

The United States should work with China to develop formal mechanisms—some of which are already in existence—that can identify questionable rules and practices, hear arguments from affected parties, and deliver advice to the appropriate governmental body on the WTO-consistency of the rule. This would give the Chinese government the opportunity to continue, in a structured and unified way, its review of its own regulations, and could serve to obviate the need for formal WTO dispute resolution procedures in many cases.

In particular, compliance and capacity-building efforts should be directed at local governments. The degree of local government commitment to reform and receptivity to WTO standards and principles varies. But almost all local governments have one thing in common: they are drastically less informed than the central government about the WTO in general and about China's specific commitments in particular. Only recently have the WTO accession documents been available in Chinese (they can now be downloaded from MOFTEC's web site), and even so it is no more realistic to expect Chinese local officials to understand their details than to expect American local officials to understand the WTO. There is a great need at the local level for seminars and workshops that will explain the basic principles of non-discrimination and transparency. Local governments need to be encouraged to set up their own offices for hearing and resolving complaints about WTO-inconsistent measures so that recourse need not be had to Beijing or, failing that, the WTO Dispute Settlement Body.

It is important, however, to pay some attention to the target audience. It may make a great deal of sense to train judicial officials in the principles of transparency and due process, for example, but they have very little need to be acquainted with China's substantive commitments under the WTO. Those commitments mean little to courts until they have been translated into domestic law. On the other hand, it is probably a good idea to train local government officials in the principles of non-discrimination and national treatment, since the granting of special breaks and favors on an *ad hoc* basis is a deeply rooted government practice as natural and unremarkable as breathing.

I sometimes think of the Chinese legal system as an aircraft carrier, and of foreign assistance projects as rowboats attempting to change its course. To a very large extent, the path of that aircraft carrier will be determined by what goes on in the engine room and on the bridge. This is a counsel not of despair but of humility, patience, and thoughtfulness. Effective compliance and capacity-building programs must be designed to work over the long term and to build relationships with specific institutions. They must strike the balance between asking too much and asking too little, either of which will lead to nothing being done. And the U.S. must be willing to work with and through NGOs, other WTO members, and multilateral organizations in order first to demonstrate that WTO compliance is not simply a narrow American political interest, and second to avoid having discussions about Chinese compliance with multilateral standards turn into possibly contentious, and certainly fruitless, discussions about U.S. trade practices vis-à-vis China.

Co-Chairman MULLOY. Professor Clarke, the testimony that you have prepared is very helpful. Let me say that your full statement will be in the record, and what we do with the testimony is we also put it up on our website so that people who come onto our website and want to learn more about these issues can do so. So even though your oral statement had to be abbreviated, I want you to know that the good work you have put in will be included.

Mr. CLARKE. Thank you.

Co-Chairman MULLOY. Thank you.

Dr. Pearson?

STATEMENT OF MARGARET M. PEARSON, ASSOCIATE PROFESSOR OF GOVERNMENT AND POLITICS, DEPARTMENT OF GOVERNMENT AND POLITICS, UNIVERSITY OF MARYLAND, COLLEGE PARK

Ms. PEARSON. Thank you for giving me this opportunity to speak with you today.

This panel has a broad agenda, and I am going to focus my comments briefly on understanding the compliance problem and also on some suggestions for how the U.S. Government might facilitate Chinese compliance.

Let me start by just seconding what Professor Clarke said about the importance of understanding that there is in many ways a domestic constituency in China that would be trying to do many of the things that WTO is fostering anyway, and the other point related to that that is all too often forgotten is that in this sense, WTO is not a unique international regime and has many of the workings of the marketplace behind it. It is the workings of the marketplace that China is attracted to, including all the international transactions that China has been engaged in. For over the last 20 years, it has been a major driving force for change in China, including with regard to trade and foreign business, and in that sense, some of the weight is lifted off the shoulders of the WTO regime and the U.S. Government for bludgeoning China into what we want them to be. Much of that work has been carried on quietly with individual transactions that are going on.

It is clear, though, that there are numerous obstacles to compliance and to achieving compliance on the schedule laid out in the agreement. I tend to think of these obstacles as falling into two broad categories, although all of them are largely political.

The first is administrative and judicial capacity, which many have noted already today. The second has to do with political leadership.

On administrative capacity, I am not sure that I have a lot to add. We do know that China has a large number of laws to rewrite and implementing regulations to promulgate. The estimates that I see range from about 150 all the way up to 2,000.

In the PRC policymaking process, there is often a significant time gap between actually writing the laws and turning out implementing regulations, and I would note that this time gap takes place even though you don't have the kind of parliamentarian wrangling that we see in this country. It is certainly going to take time to write these laws.

At present, the good news is that the Chinese Government has anticipated this need, has been doing so for a number of years, and the process is well underway. Certainly nary a week goes by at this point without announcements being made of new or newly-revised laws and regulations.

Of course, there is very much to do, but some progress has been made.

To me, the more difficult issue has to do with the need to build administrative and judicial capacity to implement the requirements at multiple levels of government across a vast region where local officials are being called on by their own government to initiate a sea change in the way they operate the economy. In addition, this is to say nothing of the fact that Chinese businesspeople have to come to understand the environment in which they now operate. China has a million village jurisdictions; it has countries many of which are the size of small nations such as El Salvador; it has provinces the size of some of our major European partners such as France. So this is no small feat. I say that not to disarm our criticism or our will to try to achieve compliance, but to say that this is the administrative reality which is being faced by the Chinese Government.

The second category of political challenge concerns political support. You all certainly know that China is in the process of transitioning to a new leadership. We don't have any reason to believe that the likely new leaders, Hu Jintao as President or Wen Jiabao or Li Changchun as Premier, will pose a big problem to WTO implementation, but they will bear the brunt of whatever political forces they must face domestically that will rise up against them, particularly the potential for social unrest.

And as for social unrest, which I am sure is on everybody's mind as well, it is common in this country to think of Chinese public opinion as being undeveloped or manipulated by the government, but it is simply not the case. There is great public awareness of the costs and benefits of WTO entry. This has grown in the past few years, and as some of our morning panelists have noted, there is currently a WTO frenzy sweeping the nation. Much of it is positive, much of it is propaganda instigated by the government in an effort to shore up public support, but at the same time, many Chinese citizens are also aware of the possibility that WTO will bring difficulty, and the government will need to respond to this. So there certainly is a great domestic challenge for China's new leadership.

Now, how can we support China's compliance? The first area I would say would be in terms of technical assistance. Consistent with this WTO frenzy, there is a slew of efforts underway within China to educate Chinese officials, judicial officials, and so forth, as well as the Chinese populace. There are also ways that people in this country in government, in the nonprofit sector particularly, are trying to facilitate that. Rather than go through those ways, I am simply going to point you to an excellent article in the newest China Business Review that covers what kinds of efforts are being made particularly within the U.S. Government and the nonprofit sector in this country to help foster compliance. It is a comprehensive review and really very telling.

I would point out, though, to the Commission that it would be foolish at this moment not to take the opportunity when Chinese officials, particularly those who are sympathetic to WTO's goals, are very open to foreign advisement and consultancy. The way I look at the situation is that we should move forward to grasp the moment and take every opportunity we can to shape public opinion and shape the administrative conditions in China, and again, many of those are underway.

The second way that I believe this Government can help compliance is in the management of China-U.S. trade friction. It is very useful always to keep in mind that, first of all, trade disputes with China will arise. It is inevitable that they will, but this rise in trade disputes is more if we look at—well, I will start by saying that most disputes that we have are with Canada, the most disputes that the WTO deals with are between the U.S. and the EU. Is this because we are trading enemies? No. It is because we have trade, and it is always useful to keep that in mind.

I'll just close by saying that it is probably most useful to help facilitate compliance by avoiding divisive rhetoric against the Chinese but continuing to work on the multiple fronts that have been laid out, both by some of the governmental programs, nonprofit programs as well, for pushing forward and keeping the pressure on China, and particularly, finally, in the multilateral front through the TRM mechanism set up in the WTO.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF MARGARET M. PEARSON

Ladies and gentlemen, thank you for offering me this opportunity to speak to you today on prospects for China's compliance with the terms and requirements of the WTO. This panel has a broad agenda; I'll focus my comments on understanding the compliance problem, and suggestions for how the U.S. government might facilitate China's compliance. The question of compliance is in significant ways one of politics, and as a political scientist who has been observing the question of China's entry to the WTO for a number of years, I hope I may be able to offer some useful thoughts and recommendations.[1]

Let me start with a few broad observations about the context in which we are seeking compliance from China. Observers of China's accession process can only be struck by how much China has agreed to do, in terms of market opening, dismantling of tariff and non-tariff barriers, leveling the playing field between domestic and foreign firms operating in China, and making its market system more robust and transparent. The reform leadership of China *agreed* to this deal; the Chinese leadership was *not* coerced into it. Among the leaders who steered the agreement through, there has indeed been a profound paradigm shift in thinking over, especially, the past four or five years. There is, in my view, no pre-existing plan to thwart or undermine compliance.

Obstacles to Compliance

However, it is clear that there are numerous obstacles to achieving compliance on the schedule laid out in the agreement. Broadly speaking, the obstacles fall into two categories: administrative and judicial capacity of the Chinese government; and political leadership.

First, on administrative capacity. This is a daunting problem, as I'm sure you are aware. China's leadership faces an administrative challenge that is equal to or perhaps even greater than European integration, and yet has a much shorter time frame and much less developed administrative structure to do so. There are a substantial number of laws to be rewritten (estimates range from 177 to well over two thousand). In the PRC policy-making process there often is a significant time gap between the approval of a law and the issuance of final (rather than interim) implementing regulations. Even in the absence of a tradition of partisan wrangling over legislation, writing laws and regulations in China takes time. The good news is that the Chinese government has anticipated this need, and this process is well underway, and has been for some time. At present, the rulemaking process has picked up a great head of steam, and nary a week goes by without some sort of announcement of new—or newly revised—laws and regulations.[2] Still, there is much, much more to do.

[1] Some of these comments reflect my participation in the Council on Foreign Relations Task Force Report, "Beginning the Journey: China, the U.S. and the WTO" (Council on Foreign Relations, 2001). While I do not agree with every bit of minutae in the report, I do support broadly the recommendations that were made about how the U.S. might support Chinese and multilateral efforts to foster PRC compliance. Of related interest is Gerrit W. Gong, Pieter Bottelier, Nicholas R. Lardy, Margaret M. Pearson, and Minxin Pei, *China Economic Brief: Issues for the New Administration and Congress* (Washington, Center for International and Strategic Studies: March 2001).

[2] In addition, MOFTEC has reorganized parts of its administrative structure to be able better to accommodate needs of WTO accession; to this end, MOFTEC has set up three new departments to deal specifically with WTO post-accession affairs.

More difficult still is the need to build administrative and judicial capacity to implement the WTO requirements at multiple levels of government, and across a vast region where local officials are being called on (by their own government) to initiate a sea change in the way they operate the economy. This is to say nothing of the need of Chinese business people to understand the environment in which they now must operate. China has one million village jurisdictions, and WTO requirements affect the vast majority of these. Many of China's countries are the size (and level of development) of small countries such as El Salvador. Some provinces are the size of European countries such as France. The passage of laws and regulations is crucial, but so is the development of the agencies up and down the administrative hierarchy and the infiltration of the rule of law to localities, such that the laws will be obeyed.

The second category of challenges concerning China's WTO compliance is political support. Here, the potential problems are also perhaps obvious, but warrant a brief reminder. One issue concerns the new leadership to which China is in the process of transitioning. If we focus on the likely inheritors of the presidency (Hu Jintao) and premiership (Wen Jiabao or Li Changchun), we have less information than we would like, but we also have reason to be optimistic. These leaders have not shown extensive opposition to the economic reforms jor to WTO, and they both have strong political skills. Still, as they come on board this coming fall and next year, they are likely to suffer the brunt of the transition problems.

What we must worry about these leaders bearing the brunt of is, of course, social unrest should China's economy fail to pull out of the doldrums, and should problems such as unemployment and dissatisfaction with local officials be made worse, in the public perception, by WTO accession. It is common in this country to think of China's leaders as unaffected by public opinion, and Chinese public opinion as undeveloped. But neither are true. Public awareness of the costs and benefits of WTO entry has grown in the past few years, and there is now what can only be called full-blown "WTO frenzy" sweeping China. Much of this is government propaganda and is supportive, but Chinese citizens, especially in the urban areas, are aware that some sectors will face great difficulty from the pressures of foreign competition. China's leaders will need to respond to public perceptions that the country is suffering at the hands of foreigners.

How the U.S. Can Support Chinese Compliance

Enough diagnosis of the context of the compliance challenge. What are the positive steps that might be taken by the U.S. government and private and non-profit sectors to foster China's compliance. Obviously the lion's share of the burden for compliance is on the Chinese government, but there are positive contributions we can make at the margins. Let me focus on three suggestions: technical support, "early harvest" options, and management of Sino-U.S. trade friction.

1. *Technical Support.*—First, we can expand on and support considerable efforts already underway in China for administrative and judicial capacity building. This will reinforce key constituencies favorable to WTO. Consistent with the aforementioned "WTO frenzy," there are a slew of efforts underway within China to educate and train central and local officials about WTO requirements and China's new laws. Business people often gain access to these training venues, furthering the education process. We must take all this as a good sign, and recognize that, already, these efforts are much more than most developing countries have made upon joining WTO.

—How can the U.S. government help? Many other countries are systematically providing China with technical assistance programs.[3] Comparatively speaking, the U.S. government has been slow to the mark. Nonetheless, U.S. efforts have begun to pick up steam in recent months. Indeed, the U.S. government—and this commission—would be foolish not to capitalize on a moment when, now that the negotiations are over, Chinese leaders of relevant agencies are considerably more open to foreign assistance and advisement on WTO issues. Moreover, the Chinese media is paying much attention to such efforts—giving a further educational outlet. Ongoing efforts by the U.S. government are being carried out by the Department of Commerce, by our embassy and consulates in China, and others. Just as important, non-profits, universities, and international governmental organizations, are playing key roles (e.g., Georgetown

[3] Additional programs from third countries include: programs to train officials from MOFTEC, the General Administration of Customs, and other organizations; the EU–China Legal and Judicial Cooperation Program; and similar training programs by the World Bank, IMF, Asian Development Bank, and United Nations Development Program. Nicholas R. Lardy, *Integrating China Into the World Economy* (Brookings Press, 2002), p. 167.

University Law Center, Harvard's Kennedy School of Government, the U.S.-China Business Council,[4] the Asia Foundation,[5] the Ford Foundation, the World Bank, and others). A timely review of such efforts has just been published this month by *The China Business Review*,[6] and I recommend it to you.

—At a minimum, the U.S. government should provide active encouragement for the excellent work currently being carried out both by government agencies and in the private and non-profit sectors. Further, the U.S. government would be well advised to support the rule of law program that has been authorized and currently is housed in the State Department, but that has not been funded.

2. *"Early Harvest."*—The Council Task Force Report calls for what it terms "early harvest" accomplishments. This means that, working closely with Chinese officials, we should attempt to produce positive early pay-offs on a small number of items. In other words, the effort would be to produce momentum *within China* as well as the U.S. in favor of ongoing WTO compliance. Within China, this would help address some of the political challenges to compliance I discussed previously.[7] The ability to show early benefits could help build a reservoir of good will and cooperation as China faces more difficult challenges.

What specific issues might be ripe for such an "early harvest" strategy?4

—In agriculture, one possibility would be to develop a program to link significant agricultural grain purchases by China with a joint venture or technical assistance arrangement enabling the movement of Chinese farmers out of what is currently inefficient grain production toward less land-intensive cash crops.

—More generally, we can support the dissemination of information in China as to the benefits to Chinese consumers of lower cost imports (such as grains) and increased exports (such as textiles and automobiles).

3. *Management of Sino-U.S. Trade Friction.*—My second suggestion for how the U.S. government can foster Chinese compliance concerns the management of Sino-U.S. trade friction. Such management involves, first and foremost, political forbearance and management of expectations about disputes. There is bound to be friction with China, and it will only rise, rather than subside, now that we have concrete standards to which to hold China. It is useful to keep in mind that trade disputes are primarily an indicator of trade, not necessarily hostility. Indeed, my understanding is that the greatest number of bilateral trade disputes the U.S. has is with Canada. Similarly, the most disputes the EU brings to the WTO are against the U.S., and vice versa. It would be wise in the case of China for the U.S. government to be circumspect about when it engages in divisive rhetoric which assumes that the source of the inevitable increase in disputes is Chinese hostility and intransigence, rather than an increase in trade. The point is to anticipate and manage expectations about disputes.

—The point is *not* to ignore problems or simply give in to China on disputes, however. Therefore, a related suggestion, also noted in the Council report, is to expand the options for dispute resolution, so as not to overwhelm an already stressed WTO dispute process. Thus, for example:

—It may be useful to energize existing bilateral dispute mechanisms, such as through the Foreign Commercial Service, or create new ones, perhaps a standing bilateral working group focused broadly on the cooperative resolution of categories of problems.

—Another possibility is private sector or joint public-private sector technical (legal) support for dispute resolution within China or the U.S.

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[4] The U.S.–China Business Council (USCBC) has overseen the creation of the U.S.–China Legal Cooperation Fund. The goal is to make targeted grants to a series of "rule of law" related programs, designed jointly by U.S. and Chinese partners. Various U.S. groups have been in, for example, distance learning courses and providing assistance to the Chinese to write an administrative procedure law, which would cover many issues core to WTO compliance. USCBC also has coordinated a series of video confrences for the purposes of training professionals in core WTO competency, helping support such efforts on behalf of the Shanghai WTO Affairs Consultation Center.

[5] The Asia Foundation is organizing a program to send specialists to China to lecture on WTO issues to officials from the central and local Legislative Affairs Office (of the State Council), and to bring them to the U.S. for several weeks' instruction on U.S. administrative law. The Ford Foundation is providing funding for some such programs.

[6] Brian L. Goldstein and Stephen J. Anderson, "Foreign Contributions to China's WTO Capacity Building," *The China Business Review* (January–February, 2002).

[7] In significant measure this effort to produce early and highly publicized benefits has been the paradigmatic strategy behind the success of many of China's gradual foreign investment and domestic reform policies. See, for example, Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (Cambridge, England, Cambridge University Press, 1995), and Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993).

—Finally, it will be wise to build an international coalition to continue to oversee compliance. Here I am not talking about the WTO's Transition Review Mechanism, which others today have spoken to; I am referring to more *informal* coalitional mechanisms within the WTO, involving the EU, Cairns Group, and other partners, to continue to urge China toward full compliance. Such coalition-building could perhaps be coordinated through the USTR, which already has extensive contacts on China's WTO membership.

—Let me close by suggesting that the USCC's annual report can play a very useful role in supporting and monitoring many of the efforts I have set forth here, particularly the management of expectations, support of alternative dispute resolution venues, and coordination of technical assistance.

Thank you for your attention.

Co-Chairman MULLOY. Thank you.

Mr. Fiedler?

STATEMENT OF JEFFREY L. FIEDLER, CONSULTANT, FOOD AND ALLIED SERVICE TRADES DEPARTMENT, AFL–CIO

Mr. FIEDLER. Thank you, sir, and thank you for inviting me.

Let me first, since you introduced me with the Council on Foreign Relations task force report—say that I would recommend that report to you even though I did dissent from it. Its underlying analysis is extremely strong.

Co-Chairman MULLOY. I think most of the commissioners have already read it.

Mr. FIEDLER. Okay. That report raises a number of flags, which I will get into in a moment, but I would like to put this in a slightly different context. I would like to go back for a second and ask why did China enter the WTO, why did it want to, and why did the United States want it to—because it is not a discussion that is had very often.

I do not believe that the basic reasoning for this was economic in the sense that we wanted to make Chinese companies rich and create American workers' jobs and make U.S. companies' shareholders better off.

I think the real reason that China wanted to come in was that its leaders made a judgment that it was the only way they could save the Communist Party.

Now, the United States made a judgment and has a policy which is also usually unarticulated to the American public on a regular basis, which is that the U.S. national interest is judged to be that China must remain stable at all costs. We need stability in China.

When you have a policy of stability being in the U.S. national interest, the maintenance of the party in power is also in our interest. So if the Chinese leaders think they need to save the Communist Party, okay; we agree. Now, I don't think that either their government or our government is thinking that WTO entrance will really save the Party, and that is the reason why compliance is going to be so difficult.

I think it is vastly understated to talk about bumps in the road. There may be sectoral bumps in the road, but I think we are heading for some major problems. Even members of the Task Force were greatly concerned about undermining the integrity of the WTO largely by having massive numbers of disputes filed within the system and that this would essentially undermine it. There is great concern out there among people that this is what is going to happen.

Dr. Pearson mentioned social unrest—she introduced the question. I want to focus on it. The real concern among most analysts is that the Chinese will not comply because massive unemployment among industrial workers who work for state enterprises will result if they in fact comply on schedule, and if U.S. agricultural products come in the way they are supposed to be allowed to because China has an uncompetitive agricultural industry. The concern is that millions of peasants—the largest group of people in the country are peasants—will revolt in some fashion.

They are already doing it in various ways today, and the Chinese Government lets some of this unrest happen and play itself out so long as people, like workers, stay in the workplace and don't take their demonstrations downtown, when they are not paid for 6 months. But the moment they move downtown, or the moment they start talking against the government or the party, then, there is a repressive mechanism in place to take care of that, and that is called the People's Armed Police.

Let's understand that Mr. Becker's brothers in China who work in steel factories—those are not tiny little factories—those are 30,000 people. You do not control their activities with a couple of cops; you do it with the People's Armed Police, which in 1984, before China started to trade a great deal with us, had 300,000 members and today has 1.5 million people whose sole job is to control workers and peasants.

Now, we make a lot of comparisons about how we are alike. We talk about the Chinese legal system as if in some respects it is a legal system. We talk about the trade unions in China. There are no trade unions in China. There is an organization that calls itself a trade union in China—it is called the All-China Federation of Trade Unions. The workers in China view it as being good for cheap movie tickets but not for representation of workers' interests.

Establishing independent trade unions in China is an illegal act. China explicitly exempted itself from the UN covenants on human rights and so on from the right of association and the existence of independent trade unions.

What do independent trade unions do? What do we do in this country? If we don't like the government's trade policy, we work against it. We may lose like we did in this case, but our alternatives are not simply to hit the streets. When the party controls the apparatus, and its job is to keep the workers down, the only alternative they have is to take more dramatic action.

The Chinese Communist Party, which is not really a communist party, but more just a party of power——

Commissioner LEWIS. The ruling party.

Mr. FIEDLER. —the ruling party—is worried more about its survival than it is about your view of their compliance. And in any instance where those two things come into conflict, you are naive to think anything other than that the party's view of itself will prevail.

Now, I don't care how many alternative dispute mechanisms you have, unless your alternative dispute mechanisms can deal with the social unrest that is likely. It is sort of like a nice academic conversation, but is other-worldly in every way.

Since I wasn't on the other panel, I would just like to add one thing on the options of leverage. The U.S. Government has all kinds of leverage. Some people have—since I proffered this notion to the Clinton Administration in certain circumstances, and there were various shudders when I did so—forced labor imports to the United States from China are, by the way, not allowed under the WTO.

The inspection of Chinese ships for forced labor products is about the best leverage you could have, especially if you only use two or three inspectors. It would take about 3 days to have ships backed up to Hawaii to get people's attention, if Mr. Zoellick is as macho as he was described earlier this morning.

I see my time is up. Thank you.

[The statement follows:]

PREPARED STATEMENT OF JEFFREY L. FIEDLER

Thank you, Mr. Chairman, for this opportunity to appear before the Commission. Hopefully, I can contribute in some measure to your deliberations concerning the public policy issues likely to face the United States regarding Chinese compliance with its WTO commitments.

Over the two couple of years I had the opportunity to serve on the Council on Foreign Relations Economic Task Force on China. Its report was issued in early October, 2001. While I dissented from the reports conclusions I would recommend it to you for the strength of its analysis of the underlying problems confronting China and the WTO.

I would much prefer, in the short amount of time we have at this hearing, to focus on what I feel are some of the most serious issues related to Chinese membership in the WTO. Also, I would like to place these issues within a context that is broader than typically discussed. While the vagaries of the WTO are technical, arcane, and often brutally boring, the fact remains that the actions taken by member states and their companies have a dramatic effect upon the lives of ordinary working people, and potentially upon U.S. national security.

While China's accession to the WTO is accomplished fact, it is useful to review why it was perceived by the governments of both countries to be in their interest. Much rhetoric and complicated international geopolitical jargon was spewed forth during the political debates in the United States and in the official explanations of the Chinese government.

The reality was, I believe, simpler. China's leaders believed that their membership in the WTO was necessary to save the Communist Party. The United States government believed that only the continued rule of the Communist Party could ensure China would remain stable, and the stability of China is the paramount objective of U.S. foreign policy. One can reasonably argue, therefore, that the U.S. government agreed with Chinese leaders that continued rule by the Party, albeit not a doctrinaire communist one, but rather ruling organization operating an authoritarian government with only the tattered vestige of an ideology remaining, was in the U.S. national interest.

Certainly the U.S. government recognized the importance of the interests of its corporations and negotiated aggressively to secure them during the lengthy WTO negotiations process. But, these economic interests were also perceived to be helpful in maintaining the legitimacy of the Party and furthering U.S. national security.

Warren Christopher, as Secretary of State, delivered a major speech that touched on the importance to the United States of stability in China. Other than this speech, there are few other utterances by Clinton administration officials about the importance of stability. There are none yet from the Bush administration. This is not so difficult to understand. Most people in this country would probably think such a policy cold, unbecoming of the United States, and China's leaders undeserving of such support. Therefore, it has always been easier and more palatable, for our leaders to sell China's WTO membership as creating a huge number of jobs for Americans while arguing that capitalism inevitably builds democracy. Neither is true, but it sounds much better than the stability argument.

While "stability" may be the objective of both governments, it is not a foregone conclusion that China's participation in the WTO will help it achieve it. Chinese leaders argue to the Chinese people that compliance with WTO rules is necessary if China is to modernize its economy and take its rightful place in the international community. What is uncertain is how much suffering Chinese workers and peasants will accept as a result of more rapid "economic reforms" caused by WTO compliance. It is this concern that preoccupies both Chinese leaders, and American government and business leaders.

Millions of Chinese workers still work for inefficient and uncompetitive state enterprises. Many millions more are still employed in agriculture, also largely uncompetitive in international markets. The Chinese banking system is fragile, largely because of bad loans to state enterprises. Corruption is still rampant, the rule of law virtually non-existent, and even modest political reform slowed as the generational change of leadership is orchestrated. A social welfare safety net is still a dream.

The gamble is that China can comply with its WTO agreements by managing the "social unrest" that is certain to follow from decisions such as closing large state enterprises or letting them go bankrupt. We are already hearing from many in the U.S. foreign policy community that we should be understanding even forgiving of Chinese non-compliance with its WTO obligations. We should be developing alternative dispute resolution mechanisms, they argue, including bilateral ones so that the WTO system is not overwhelmed by the filing of disputes.

This is clear recognition by these analysts that massive unemployment and the unrest it is likely to cause will persuade the Chinese government to slow or stop compliance in order to keep the Party in power. Stability is the primary concern. Managing change on this scale would be a daunting task for any democratic government. It is even more daunting for an authoritarian government such as China's.

The situation of urban industrial workers is likely to be most critical in the short run, although the condition of peasants should not be understated.

How the Chinese government manages this unrest presents a serious dilemma for U.S. policymakers. Allow me to provide a quick overview of the problem as we in the American labor movement see it.

The existence of independent trade unions is illegal in China. Only the Communist Party controlled All Chinese Federation of Labor (ACFTU) is allowed to "represent" workers. The ACFTU Chairman is a senior Party official who also sits on its important "Social Stability" committee. The ACFTU has no credibility among Chinese workers and been completely impotent to prevent such problems as the failure of state enterprises to pay workers for months on end. Spontaneous strikes are common. Workers who lead them, or attempt to form real unions are jailed. In fact, the ACFTU's real purpose is to control workers not represent them. Real collective bargaining does not exist. The top ACFTU official in a workplace is usually also the Deputy Plant Manager. In short, workers have no voice. Their only alternative is drastic action—demonstrations, taking managers hostage in plants, and the like.

The Chinese government currently tolerates a certain level of unrest since it knows the grievances are legitimate. But when things appear to be to well-organized, spread into the community, or turn into protests against the government, the People's Armed Police (PAP) is brought in to repress the workers and peasants.

In the early 1980's the PAP numbered approximately 300,000. Today they are 1.5 million strong. Their primary purpose is to "maintain social stability"—read repress workers and peasant protests. Unlike the 1989 demonstrations, these protests are not broadcast on television to the rest of the world. But, if they become widespread, they will become as important, perhaps even more important than those of 1989.

What will the United States government do when the Chinese government uses the PAP to repress workers in the name of WTO compliance? The current answer appears to be we should let the Chinese government slow its WTO implementation so the most brutal forms of oppression are not necessary. It is unclear whether U.S. corporations who think investment and trade in China are important to their futures will sit quietly as the Chinese do not live up to their commitments.

Repression is difficult, if not impossible to "manage" over time. If it is the policy of the United States to help the Chinese repress workers and peasants to secure WTO compliance, there will certainly be domestic political implications in America. The absence of institutions forming the rudiments of civil society and even modest political pluralism, make the prospects of WTO compliance dim. All the alternative dispute resolution mechanisms our most creative minds can conjure can do little more, in my view, than delay the inevitable realization that China's leaders top priority is their survival rather than WTO compliance and that the two goals are incompatible.

Co-Chairman MULLOY. Mr. Fiedler, I'm sure there will be questions. That was a very interesting perspective, and we thank you for it.

The point that you made about the party not being a communist party, I think we gathered that impression during our own trip, that it is not a Marxist party—it may be a Leninist party——

Mr. FIEDLER. It is closest to fascist, actually.

Co-Chairman MULLOY. Okay. Thank you.

Mr. Stewart?

STATEMENT OF TERENCE P. STEWART, ESQ., MANAGING PARTNER, LAW OFFICES OF STEWART AND STEWART

Mr. STEWART. Thank you, Commissioner.

I'll try not to repeat points that others have made. China's accession to the WTO is in many ways a great experiment. It is an experiment for China, and it is obviously an experiment for the rest of the world that is trying to figure out a way to blend them into the trading system on terms that are understood by the rest of us and that have some hope of permitting a balance in the trade relationship. In that context, listening to the comments of the earlier panel, it is not that we had eliminated the trade deficit with China before they joined the WTO, and the tremendous leverage that we may have had under domestic law or the capabilities to take unilateral action in fact were seldom if ever used. So I think that while one can argue the merits of the deal and whether a better deal could have been or should have been negotiated, now that they are a part of the party, the issue becomes is it likely that there will be significant compliance, and if there is not, how does one move in the direction of getting significant compliance.

Looking at what China has done in fact, the obligations of membership require compliance at the time of accession, that is, December 11; so it is not the case that after-the-fact implementation is technically what is normal or what is viewed as appropriate unless there is a phase-in time period.

And if you take a look at the notices out of China, in fact there have been dozens, probably hundreds, of laws and regulations that have been modified. There is much that a nation can do to bring itself into compliance technically, and at least in these early days, it would appear that China is working hard to in fact do those things which can be done by law or by regulation, and there are some areas where one would expect there to be good compliance in fact—tariff rates, as an example. Tariff rates were reduced on January 1, 2002 in accordance with the obligations. One would expect that as the later reductions in tariffs called for by the agreement become due that those will be put into place. That is something that is easy to see, easy to verify, and companies should be able to tell immediately whether or not their goods going into China are subject to the duties that have been agreed to.

Most of the discussion from the first panel and I think from this panel as to where there are going to be problems—they are in all those areas where it is not so simple, where it is not simply a question of what is the tax rate that is going to be applied, but rather, it is a question of how does a government agency or state-owned enterprise choose to conduct itself where you are talking about very substantial changes in human behavior or changes in institutions. And there is no doubt that we already see in China many instances where that is not occurring and probably won't occur rapidly, despite the best efforts—even if one assumes best efforts by the Chinese Government and by all of the trading partners who have an interest in that being done.

So your inquiry today and part of the function that the Commission is serving is obviously very important, because American businesses have been losing for years billions and billions of dollars of sales every year, and we are likely to continue to lose billions of dollars in trade. So the issue is how you move to full compliance, meaning literally tens of thousands of jobs for Americans, and our achieving the benefit of the deal that has been cut.

Many of the problems identified, whether it be in agriculture, in the SPS issues that our soybean producers are facing in their exports to China or otherwise, are not unique to China. We are facing those problems with the Europeans and virtually any country that is a member of the WTO that is sensitive to agricultural imports, which is the vast majority, unfortunately, of our trading partners.

And much of the problem that exists there really comes down to the fact that the agreements use very vague terms, don't have clear resolution of important issues, GMO being a classic example, where there are two violently opposed camps within the trading community at the moment as to what is right and what is permissible. And China will undoubtedly do that which they perceive to be in their economic interest by not letting goods in even though from the United States' perspective that is a problem.

There is this interesting review mechanism which is similar to the Trade Policy Review Mechanism that all members of the WTO go through. The United States goes through it every 2 years. China will be asked to go through it every year. That is a major vehicle to apply peer group pressure. I would think the most important thing this Commission could do would be to work with the Administration to get confidential reports on a quarterly basis of the number of complaints that have been raised and what the resolution is. There are many, many mechanisms in place already. This Administration and the prior Administration have been working hard to find ways to identify problems, bring them up at the local level, and move them up the chain of command. What there is not publicly available is any information as to the success rate. Because there are going to be hundreds and thousands of issues that arise every quarter, the best information you could have is how well is that working, because whether you need to inundate the WTO with formal disputes really depends on how responsive the Chinese Government is to the bilateral process when obvious issues arise. There will be issues on which there are differences of opinion as to the agreement. Many of the early issues are going to be issues in which it is not a question of difference of opinion, but it is simply a failure of implementation on the part of Ministry "X" or state trading enterprise "Y." The best thing the United States could do would be to get an early read as to how effective the bilateral informal process is going to be and to push hard to make that effective so that the other mechanisms that are available but which are much more confrontational do not need to be used.

I will stop before the red light comes on.

[The statement follows:]

PREPARED STATEMENT OF TERENCE P. STEWART, ESQ.

The road to accession for the People's Republic of China was a long and complicated one. During the fifteen years of the journey, China made profound changes to its economic system. These made China more able to accept the obligations of membership. Nevertheless, of all the accessions to the WTO or its predecessor entity, the GATT, China's was the most challenging both for the acceding country and for the existing membership. This was due to basic economic differences coupled with China's size and extraordinary economic and trade growth in the time period during which accession discussions took place. Because its economic system remains different from a market economy in many ways and because of practical problems trading partners experienced in China's inability to implement commitments throughout the country that could affect the benefits expected by other member countries from China's accession, WTO members explored and required extensive commitments which they hoped would make membership a beneficial experience for the existing members as well as China. At the same time, China has been unable to accept all obligations its trading partners required for membership at the time of accession. This means that there are many commitments that will be undertaken over time rather than immediately upon accession.

These same differences in economic systems and the tremendous trade flows China has been able to generate over short periods of time, have led a number of important trading partners to take actions outside of the WTO rules to protect domestic interests. These actions by China's trading partners will be phased out over time. Similarly, the membership generally felt it necessary to have special rights to address trade surges from China until such time as China has fully implemented all obligations including those to be adopted after accession.

Finally, because of the enormity of the task before China and the many commitments that phase in over time, existing members have insisted on an annual review process to monitor implementation of obligations by China (China is also able to comment on compliance of other members actions in certain areas during the review).

COMPLIANCE WILL BE A WORK IN PROGRESS FOR MANY YEARS

It would be unrealistic to assume that China can implement its commitments fully and timely at accession or as new obligations come due. This is not an excuse for Chinese non-performance but rather a reflection of what is left to be done and the likely difficulties in developing the institutions and new patterns of behavior needed for full implementation in a timely manner.

China has been doing a great deal in terms of adopting and modifying laws and regulations. Hence, many obligations undertaken by China will be met in terms of statutory or regulatory language consistent with obligations. Implementation of those laws and regulations, however, presents many new challenges. Some areas should be easier to implement than others. Problems are more likely in areas where enforcement actions are required by Chinese government officials or where the same government ministry is regulating foreign investors and state-owned enterprises. In such situations, there are often tremendous training needs, institution building and even cultural modifications needed for truly effective and fair implementation. As the U.S.-China Business Council noted in its September 2001 review of PRC implementation (page 1), "Uneven enforcement of IPR laws remains the central problem in China's IPR regime." This is true even though IPR rights and enforcement have been the subject of bilateral agreements and cooperation for many years.

WTO Members have a right to expect China to have modified all laws at the time of accession that would need modifications. Clearly much has been and is being done. See, e.g., The U.S.-China Business Council, June 2001 and September 2001 write-ups "Toward WTO: Highlights of PRC Implementation Efforts to Date." Laws modified in recent years include laws in the rules area (antidumping and countervailing duty laws in China), intellectual property laws (to conform to Trade-Related Aspects of Intellectual Property Rights ("TRIPs") obligations) and joint venture laws (to conform, inter alia, to Trade-Related Investment Measures ("TRIMs") obligations). Regulations are being adopted in many areas (e.g., telecommunications) as part of the conformance program. Consider, for example, the following eighteen notices from China's Ministry of Foreign Trade and Economic Cooperation just in December 2001 addressing actions to implement WTO obligations, to enforce those obligations or to alert domestic producers of changed rights/obligations under the WTO:

—12/30/2001, China Issues Governing Regulations for Overseas Financial Institutions

—12/30/2001, WTO Entry to Challenge China's Administration System ("After the accession, 25 of the 30 government administrative regulations that need drafting or amending have been completed while 12 others have been abolished. The implementation of 36 State Council documents on administration will be stopped very soon")
—12/30/2001, Private Firms to Be Allowed to Import Oil ("decision was made in accordance with China's commitments made on joining the World Trade Organization")
—12/28/2001, China Seizes Over 114 Million Illegal Audio-Visual Products (seizures in 2001)
—12/27/2001, China Publishes Chinese Version of Agreements on Its WTO Entry Online ("MOFTEC published the full English text of legal documents concerning China's accession to the WTO on its website on December 10. A guide book and bilingual version of the legal documents will also be published after the Chinese full text version is formally presented.")
—12/26/2001, China Completes Rectification of WTO-related Laws ("China has completed the rectification of six laws, making them all conforming to the rules of the World Trade Organization (WTO)." "The six laws are: the Law on Chinese-Foreign Equity Joint Ventures, the Trademark Law and the Copy Right Law that were revised this year and the Law on Chinese-Foreign Contractual Joint Ventures, the Law on Foreign-Capital Enterprises and the Patent Law that were rectified last year. The six laws concern the use of foreign capital and the protection of intellectual property. Zhang said amending of such laws is in the spirit of the WTO and represents the principles of 'national treatment' and 'most-favored-nation clauses'.")
—12/24/2001, New Regulations for Management of Overseas Funded Insurance Companies
—12/18/2001, China's First Telecom Joint Venture to Start Service
—12/17/2001, First Life Insurance Firm Open to Overseas Investors Set up in China ("Heng'an Life Insurance Co., the first life insurance company authorized to set up a joint venture with overseas investors since China joined the World Trade Organization last week, was launched Sunday in Tianjin.")
—12/14/2001, China to Improve Statistics Quality with IMF Standards ("The move is part of the Chinese government's drive to improve the quality of statistics and service in response to transparency requirements after the country's entry into the World Trade Organization.")
—12/14/2001, New Body to Handle Anti-dumping
—12/13/2001, China Promotes Anti-Dumping, Anti-Subsidy study ("Ma said fair trade policies and laws concerning imports and exports are important parts of China's foreign trade policies and laws. China will not only make anti-dumping, anti-subsidy and safeguard investigations against imports on the basis of WTO rules, but also guide domestic enterprises to actively defend their rights and interests in investigation cases against Chinese exports.")
—12/13/2001, China Issues Protection Code for Local Industries (anti-dumping, anti-subsidy and safeguard provisions)
—12/12/2001, China to Cut Tariff Level to 12 Percent by End of 2002 ("China is to cut the average level of tariffs of imported goods from the current 15.3 percent to 12 percent by the end of 2002, the Ministry of Finance announced Tuesday. The reduction of tariffs will begin from January 1, 2002. The Chinese government has decided to lower the tariff rates of 5,300 items in 2002, accounting for 73 percent of the total items of tariffs." "He said in the next few years, China will continue to cut the tariff rates step by step according to its duty under the WTO.")
—12/10/2001, China to Allow Renminbi Business for Overseas Banks in Shanghai, Shenzhen ("China will allow overseas financial institutions in Shanghai and Shenzhen to engage in Chinese Renminbi business as of December 11, the day when China will formally become a member of the World Trade Organization")
—12/05/2001, 2002 to See Greatly Cut Auto Tariffs/Restrictions by China ("China's auto tariffs on auto imports will be cut to 25% level starting from 2002 to July 1, 2006. Of these the biggest cut will be seen in 2002 and scrapping of auto quota licensing in 2005." "Apart from tariff cuts on auto imports the official further noted that there are also some other commitments to be honored as compulsory. One is related to a complete scrapping of preferential policies honoring domestic auto products. Two is for a repeal of man-made restrictions on manufacturers' investment, auto models and types to be developed by 2003, making sure every manufacturer has the right to produce the types or auto models of their own choice. Aside from the above said, limits to a fixed JV share not over

50% by foreign partners will also be cancelled immediately after China's entry of the WTO.")

—12/05/2001, Preparation for WTO Entry Well Under Way: Trade Minister ("The preparatory work for China's accession to the World Trade Organization (WTO) is going smoothly, said the Minister of Foreign Trade and Economic Cooperation Shi Guangsheng Tuesday." "China is busy revising and adjusting laws, to provide legislative assurance for the new situation after the entry. After completing the amendments to most national laws and regulations, China has started checking local laws and provisions.")

—12/04/2001, China's Pharmacy Sector to Explore New Ways for WTO Entry ("In 2000, the medicine manufacturers ranking the top ten in the world reported a sales volume accounting for about 47 percent of the global medicine industry. However, about 97 percent of the Chinese-made medicine and raw medicine made in China are somewhat copy of those made in the developed countries. With China's newly WTO entry the implementation of regulations on intellectual property protection will forbid the random replication of foreign patented medicine, which will be a great challenge to China's national pharmaceutical industry.")

Nonetheless, implementation issues are likely to be paramount to the smooth integration of China into the global trading system. Concerns of WTO Members about China accession have included, inter alia, the uniform administration of laws and regulations, particularly in special economic zones, transparency of the governmental rules and regulations and the process of modifying such laws, obtaining adherence of local governmental laws and regulations to WTO obligations undertaken by China, providing judicial review of all administrative actions on relevant trade matters and timely implementation of all obligations under the TRIPs Agreement. These are all areas where there are significant changes in behavior required and conformity by entities that are not as committed to WTO implementation as the reform part of the Chinese government. The enormous effort expended by the U.S. (and by others such as the EU) on TRIPs issues and enforcement throughout most of the last decade demonstrates the level of difficulty of obtaining full compliance in some areas even where there is strong technical assistance. Press accounts have suggested that as much as 85–90% of computer software and audio/visual products sold in China continued to be counterfeit in 2001 despite stepped up enforcement efforts and many years of training and assistance.

This is not to say that China is not making efforts to build the institutions and develop the training needed to obtain compliance. For example, WTO training programs for government officials have been instituted, government and private sector individuals have participated in conferences in China and attended programs in the U.S. and elsewhere and there will be many requests for technical assistance by China to the WTO in the months and years ahead. The process of meaningful implementation of new obligations, however, has not been easy for existing WTO members and will almost certainly present enormous challenges for the Chinese government in the months and years ahead. Thus, China and its trading partners should both be interested in seeing the maximum level of technical assistance and the broadest array of tools to monitor compliance so as to facilitate the steps that will obviously be necessary.

THE WTO TRANSITIONAL REVIEW MECHANISM

The WTO Agreements contain extensive transparency obligations for members in the form of periodic notifications of laws, regulations and programs. Trading partners regularly review and make inquiries about new laws or regulations or special government actions in the context of the numerous Committees that make up the WTO. Moreover, during the Uruguay Round itself, countries agreed to an overall periodic review of each member's trade regime and progress in liberalization and identification of concerns by trading partners. Thus, there has always been a mechanism within the WTO to pursue issues of compliance outside of the dispute settlement process. In addition, as noted above, the WTO provides a significant amount of technical assistance to countries interested in better understanding various agreements while other multilateral organizations (e.g., WIPO) have worked with countries needing assistance implementing obligations under certain agreements (e.g., TRIPs). Similarly, individual nations have provided funds to the WTO or offered technical assistance directly to other nations that have needed help in implementing their obligations. The fundamental purpose of all of these efforts is to ensure that Members can and do meet their WTO obligations. All of these transparency obligations and assistance programs will similarly apply or be available to China now that it is a Member of the WTO.

Uniquely, China must also go through an annual review under Section 18 of the Protocol of Accession for each of the first eight years and a last special review in the tenth year after accession. While Section 18 permits China to "raise issues relating to any reservations under Section 17 or to any other specific commitments made by other Members in this Protocol" (18.1), the stated purpose of the exercise is to "review . . . the implementation by China of the WTO Agreement and of the related provisions of this Protocol." (18.1) The primary benefit of this mechanism is to maintain focus of the WTO as an entity on China's implementation. Section 18 does not provide for a separate remedy, so its purpose is primarily to provide peer group pressure for conformance to obligations undertaken.

The annual review mechanism neither provides new remedies nor bars recourse to existing WTO remedies. As is made clear by Section 18.3, "Consideration of issues pursuant to this Section shall be without prejudice to the rights and obligations of any Member, including China, under the WTO Agreement or any Plurilateral Trade Agreement, and shall not preclude or be a precondition to recourse to consultation or other provisions of the WTO Agreement or this Protocol." Thus, while information developed might help Members understand how China is implementing its obligations in fact, the annual review doesn't create new obligations and can't prevent Members from pursuing their rights through dispute settlement or otherwise.

Annex 1A to the Protocol (WT/L/432 at 13–18) requires a large amount of information which presumably will permit individual countries to measure the effectiveness of China's actual actions in meeting its WTO obligations. There are requests for large amounts of economic data that will help Members understand trade flows and whether certain forms of historic discrimination on foreign products (e.g., VAT and VAT rebates) have been eliminated. The data will also allow Members to determine whether certain obligations have been met (e.g., elimination of export duties or taxes). Information is also required on laws and regulations. Such information will go to various WTO Committees or Councils depending on jurisdiction. Consider the following outline of areas where information is required to be supplied by China:

ECONOMIC DATA (10 TYPES OF INFORMATION)

Economic policies

Non-discrimination
Foreign exchange and payments
Investment regime
Pricing policies

Framework for making and enforcing policies

Structure and powers of the government/authority of sub-central governments; uniform administration

Policies affecting trade in goods

Tariff rate quotas
Non-tariff measures
Import licensing
Customs valuation
Export restraints
Safeguards
Technical barriers to trade
Trade-related investment measures
State-trading entities
Government procurement

Policies affecting trade in services (five areas where data are required)

Trade-related intellectual property regime

Specific questions in the context of the transitional review mechanism

While one will not know how the transitional review process works in fact until at least one or two reviews have been concluded, it is likely that both China and its major trading partners will put significant energy into the process to help China with its implementation commitments. Stated differently, the review process should be a win-win for China and its trading partners. I assume that the U.S. government will use not only the various agencies involved in monitoring China's compliance with obligations but also the many private sector sources (whether formal such as the advisory committees and individual company/group identification of problems or informal such as working with the U.S.-China Business Council, U.S. Chamber, NAM and other groups with an active interest). Importantly, this Commission can play an active role by helping to identify areas of interest/concern and by making recommendations on steps the Administration and Congress can take to ensure that the proper level of technical assistance is available from multilateral and plurilateral organizations and from the U.S. government and private sector.

WTO DISPUTE SETTLEMENT—AVAILABLE BUT THE LAST APPROACH

The WTO dispute settlement system has been increasingly used by member nations to resolve matters where bilateral consultations have proven inadequate to achieve change in practice by one or more Members. Certainly, the U.S. and other WTO members have the right to bring challenges to China's actions if they so choose. I would expect relatively few formal challenges in the first few years of China's accession—assuming general good faith efforts by China to fulfill its obligations.

As a general matter, WTO members usually provide a de facto grace period free from formal challenges to new members. During this period, Members typically focus on technical assistance needs as well as engaging in bilateral discussions to identify problems and the need for corrective action. Refusal to act or inability to act because of internal problems could be reasons for going to formal dispute settlement procedures, and the U.S. will want to be prepared and willing to use the process where warranted. Other new members have typically been much smaller participants in the trading system and so the past may not be a good gauge of the future for China. But I believe we will see general restraint before cases are brought, again assuming a general good faith effort by China to implement obligations undertaken.

It must be remembered that while the dispute settlement system has been successful in many cases in resolving disputes, the process is time consuming (it can take several years from initial request for consultations until the time for implementation of changes has arrived). Moreover, the system does not have the capacity to handle large numbers of cases in any given year. For example, the November Update of WTO Dispute Settlement Cases (through November 5, 2001) showed the following results and pending matters [WT/DS/OV/2]:

Adopted panel and Appellate Body reports (since 1995) = 56 cases.

Active panels = 18 cases.

Settled or inactive cases = 33.

Cases in consultations (includes cases that have been inactive for a number of years) = 93.

The dispute settlement system is an important guarantor of adherence to the obligations undertaken by all members. Under a properly working system, Members will only resort to the mechanism where efforts at bilateral resolution have been unsuccessful and where significant matters are at stake.

BILATERAL COOPERATION AND FOCUS

The U.S. has had an active program of technical assistance for many acceding countries to the WTO where there is a need for assistance and a willingness to receive it. During the accession process for certain countries, the U.S. has sent technical advisors who are able to coordinate U.S. agency support to help acceding countries understand what the WTO obligations are and ways that compliance might be obtained. For example, the Customs Service has worked with many countries on issues such as enforcement of TRIPs issues at the border, Customs Valuation and other matters. The same has been true for other agencies. For China, there has been and will continue to be significant support from the U.S. and from other countries as well as the WTO as an entity.

The U.S. government is also devoting resources to monitor implementation at many agencies, including USTR, Commerce, State, Labor and Agriculture. This is a critical first step so issues of concern can be identified quickly and brought to the Chinese government's attention for action. In the January 2002 Export America, the Department of Commerce reviews steps that have been taken to permit bilateral resolution of problems (pages 25 and 26).

Commerce's China Team holds semiweekly strategy sessions to review cases and implementation plans. A new China-specific website ( ) provides U.S. business with detailed information on China's WTO obligations, compliance and market opportunities. China Team representatives meet regularly with the commercial staff from the Chinese Embassy in Washington, D.C. and Commercial Service officers meet regularly with Ministry of Foreign Trade and Economic Cooperation in Beijing, to review specific market access and compliance problems.

In Beijing, Commercial Service officers, along with State Economic officers, Foreign Agricultural Service officers and Customs Attaches, participate in a WTO Implementation Coordination Committee which meets regularly to assess progress and monitor problems, with input from U.S. consulates in Shanghai, Guangzhou, Shenyang and Chengdu.

The private sector obviously has a critical stake in timely and full implementation by China of its many obligations. Our companies will experience the problems and face the loss of business and other difficulties if obligations are not complied with as promised. While many problems will be addressed with local authorities, U.S. companies can and should work with the U.S. government in China and at home to get problems addressed where needed. Organizations like the U.S.-China Business Council, the U.S. Chamber and NAM are actively working on monitoring implementation and should become important resources for identifying problems and searching for rapid solutions.

CONCLUSION

China's accession to the World Trade Organization is a very important event for China, for the trading system and certainly for the United States. China has assumed many obligations. Initial reports suggest that China is making major strides in adopting legislation and regulations related to WTO obligations. It is equally clear that many of the obligations assumed by China go well beyond adopting legislation or regulations and will likely take significant time before fully implemented. Technical assistance, education, close bilateral working relationships and, where necessary, formal challenges will all have a role in ensuring that the world's most populous nation fully implements the obligations assumed and provides the market access envisioned by our negotiators. Realistically, full implementation will take time.

Thank you for the opportunity to appear today. I would be pleased to respond to questions.

Co-Chairman MULLOY. Thank you, Mr. Stewart. That was a very helpful piece of testimony.

Mr. Brody?

STATEMENT OF DANIEL J. BRODY, EXECUTIVE DIRECTOR, U.S. INFORMATION TECHNOLOGY OFFICE, BEIJING, CHINA

Mr. BRODY. Thank you, Commissioner.

As you mentioned, we had a chance to speak earlier, so I'll keep my remarks extraordinarily brief.

First, just to introduce myself, I am from USITO, the U.S. Information Technology Office, which is the joint rep office for six American high-tech trade associations including AEA, CSPP, ITI, SIIA, SIA, and TIA.

I'll just make three quick comments. The first is on China's economy and the IT industry in China; second, on policy areas that the American high-tech industry is concerned about; and then, general impressions.

In my written testimony, you have our overview of the overall economy, foreign trade, IT sector, telecom, semiconductors, computers, and the internet.

I will just briefly point out that the IT sector in China, which is extraordinarily large in terms of industrial output—$200 billion, which is GVO or gross value output, a US$200 billion value; sales revenue of $100 billion; but industrial value added is only $24 billion, and profits are a fairly paltry $7.8 billion.

I would also indicate that the telecom sector adds 5 million wireless subscribers per month for a total of 145 million by the end of 2001. In comparison, the U.S. has 121 or 122 million.

And in the computer sector, China is now the second-largest market in the world, surpassing Japan this year with 13.2 million computers compared to Japan's 12.7 million, behind only the United States.

In terms of industry monitoring, it is a little bit early to say. We have only been in for 6 weeks, and U.S. industry has not yet set its priorities, but we will be doing so here in D.C. over the course of next year.

There are eight areas that we are looking at preliminarily, of which I will only highlight the first, which is China's adoption of the Information Technology Agreement. Mr. Stewart mentioned the 5,300 tariff lines which were reduced; of those, there are 251 IT products which went to zero as of 2 weeks ago, January 1.

The USITO has conducted a study based on both ITC Customs statistics as well as Chinese General Administration of Customs Statistics, of 30 different four-digit HS tariff codes, which are defined by AEA as high-tech products. Chines trade statistics show $6 billion in direct, U.S.-to-China—not going through Hong Kong, not going through any other third country—high-tech product trade. The study of the top 10 of those goods by GAC—the top 10 goods by GAC. The full 30 codes according to the ITC account for $4.5 billion in trade, based on an average tariff code of 10 percent and in addition based on a line-by-line analysis where we took the amount of trade, stipulated a 10 percent increase in trade next year, and then, according to the new tariff rates of zero percent or 3.8 percent or whatever, direct U.S. exports to China will save $500 million next year alone, at least. That's a fairly conservative estimate, and I can share my methodology if you'd like. But that is a fairly direct and immediate benefit to U.S. companies that is coming.

Commissioner LEWIS. Would you repeat that statement again, please?

Mr. BRODY. U.S. direct exports of high-tech products from the U.S. to China in 2002 alone will save $500 million on import tariff payments to China's Customs.

Commissioner LEWIS. Thank you.

Mr. BRODY. There are seven other areas that we are looking at as major points of interest, nontariff barriers—product standards, conformity assessment, TRIPs, TRIMs, SOE purchasing, trading and distribution rights, and of course, telecom services.

Finally, I would just not that we work on the ground with visiting officials and visiting delegations of U.S. companies, and of course, our board of six parent associations here in D.C. stands ready to assist you in your work.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF DANIEL J. BRODY

INTRODUCTION

My name is Dan Brody, and I am the Executive Director of the United States Information Technology Office (USITO) in Beijing, China. Thank you for inviting me to appear before you today and to join these distinguished panelists.

USITO is a trade organization designed to promote trade and cooperation in the information technology industries of the United States and China. It is committed to increasing the market share of U.S. companies in China's burgeoning information technology sector. USITO is a consortium led by: AeA (formerly the American Electronics Association), The Computer Systems Policy Project (CSPP), The Information Technology Industry Council (ITI), The Software & Information Industry Association (SIIA), The Semiconductor Industry Association (SIA), and The Telecommunications Industry Association (TIA).

Outline

This panel has been convened to discuss China's commitments to and compliance with its terms of accession to the World Trade Organization (WTO). Since China officially joined the WTO on December 11, 2001, time has been far too short for me to discuss in any detail China's compliance with its WTO obligations. Therefore, I will focus my remarks on three areas:

—The Chinese economy and the IT industry in China;

—The policy areas the American high-tech industry will be monitoring with respect to China's terms for accession, and;

—My general impressions related to China's compliance with its commitments.

ECONOMIC OVERVIEW

I'd like to review a few key economic indicators to explain why China's market is important to the American high-tech sector.

Overall Economy.—Government spending still accounts for a large portion of economic growth. Even though the non-state sector now accounts for over half of output, the core group of state-owned enterprises (SOEs), especially a few large SOEs, still dominates China's economic activity in select downstream industrial areas.

Foreign Trade.—China has risen to become the world's 7th largest trading nation in 2001,[1] jumping 2 ranks from 9th in 1999 and up from 32nd in 1978.

—"Electronics and Machinery" is expected to grow at 10% year-on-year during the 10th Five Year Plan (2001–2005), with electronics exports growing at least 15% year on year.

—With overall exports expected to grow at a slower pace, this means that electronics are expected to grow to account for roughly half of China's exports by 2005.

IT.—China's information technology (IT) manufacturing sector is very large but relatively weak. This is most graphically illustrated in the extremely high revenue but extremely low profit margins regularly displayed by the sector. China IT/manufacturing sector in 2001 reached industrial output of $198.8 billion, sales revenue of $108.4 billion, value add of $24 billion, but profits of only $7.8 billion.[2]

Telecom.—China's telecom sector has received a great deal of attention in recent years, due to its rapid growth and large size.

—China's mobile and fixed line networks and number of subscribers have become either first or second in the world, rivaled only by the U.S. and growing at a faster pace.

—Throughout 2001, China added roughly 5 million new wireless subscribers per month. Preliminary statistics indicate that China's telephony users have reached 324 million by the end of 2001.

—Telecom services revenue (all types) increased 165% year-on-year to approximately $47.83 billion.[3] China continues to break up monopolies, introducing competition.

Semiconductors.—The current semiconductor market in China is estimated to be up to $8 billion per year. China is the third largest semiconductor market and is expected to become the second largest by 2010. China's domestic production can only account for 20% of domestic demand, meaning that 80% of demand is met by imports of foreign semiconductors. The current semiconductor equipment and materials market in China is estimated to be over $1 billion per year and is projected to reach almost $4 billion in 2003.

Computers.—The International Data Group, a research firm, forecasts that 13.2 million computers will be sold next year, surpassing Japan as the world's second-largest PC market.

Internet.—At the end of last year, the number of Internet users in China reached 33.7 million, up 49.8 percent over the year before. China has 12.54 million computers linked to the Internet, an increase of 40.6 percent over the same period in 2000. China also has over 2,000 Internet Service Providers in operation.

With the overall IT industry expected to grow between 20–40%, the American high-tech sees enormous potential in being involved in the dynamic Chinese IT market.

INDUSTRY MONITORING

China has undertaken significant reform of its economy, internally and through its WTO commitments, and the American high-tech industry will be monitoring sev-

[1] IMF statistics.

[2] MII Dept of Economic Operations.

[3] ibid.

eral key areas of China's implementation of those commitments. The industry will monitor eight key areas:

—China's adoption of the Information Technology Agreement;
—China's elimination of non-tariff barriers;
—China's development and imposition of product standards and conformity assessment procedures;
—China's enforcement of the Agreement on Trade-Related Intellectual Property (TRIPS);
—China's adherence to the Agreement on Trade-Related Investment Measures (TRIMS);
—China's obligation for state-owned and state-invested enterprises (SOEs/SIEs) to purchase and sell on a commercial, non-discriminatory basis;
—China's provision of universal trading and distribution rights, and;
—China's liberalization of its telecommunications services market.

—The Information Technology Agreement will eliminate tariffs on most IT products by 2005. U.S. high-tech exporters are expected to save at least $500 million in 2002 alone from reduced import tariff payments, with the savings continuing to rise in the future.[4]
—China will eliminate of non-tariff barriers by 2005, including tariff-rate quotas (TRQs), import quotas, and discriminatory licensing and tendering requirements that affect many high-tech products.
—China is also obligated to develop and impose legitimate and non-discriminatory product standards and conformity assessment procedures, which are embodied in the WTO Agreement on Technical Barriers to Trade.
—China must also enforce the Agreement on Trade-Related Intellectual Property (TRIPS), which is of particular importance to: the software industry, which finds 94 percent of its products pirated, and; the protection of manufacturing, circuit, and systems utility patents.
—China's adherence to the Agreement on Trade-Related Investment Measures (TRIMS) will eliminate the imposition, particularly by local/regional authorities, of policies that were put in place in order to grow infant industries in China. These requirements forced foreign firms: to use local content as preconditions to incentives intended to attract foreign investment; to transfer technology to a local "partner," and; to export a certain percentage of production.
—China has also committed to ensure that state-owned and state-invested enterprises (SOEs/SIEs) purchase and sell on a commercial, non-discriminatory basis. SOEs make up a large portion of electronics manufacturing firms in China.
—China will also allow universal trading and distribution rights.
—Finally, the industry will monitor China's liberalization of its telecommunications services market (which includes all types of services), which is the most important factor in the development of electronic commerce.

CHINA'S COMPLIANCE

Most would agree that implementation of China's WTO commitments will likely be uneven and challenging. China has set itself on an ambitious course to modernize and reform it economy and faces difficult hurdles, including:

—Increased levels of domestic unemployment as a result of a global economic slowdown and dislocations from reforms,
—Taking into account the political needs of local and regional authorities, and
—The management and direction of a country and an economy of enormous size and complexity.

However, USITO will work closely with our member companies on-the-ground in China, as well as our parent associations and their member companies to closely monitor China's implementation of its commitments. We are confident that China will continue to be a major growth market for IT products and services, and we look forward to working with the Chinese government to assist in their transition to a market economy, based on the rule of law and respect for WTO commitments.

[4] USITO calculated savings by two methods. First, assuming the average tariff drop on Jan 1 for a single product is 10% and overall trade is around $5 billion ($4.5 by U.S. Customs and $6 billion for the top 10 high tech items alone by China's GAC). Second, line-by-line information on HS imports for GAC for 2000 and assuming a 10% rise in imports for 2001, a fairly conservative estimate, with new tariff rates, results in $418 million in savings for the top 10 high tech products alone. The top 10 high tech products refer to the 10 4-digit HS codes that accounted for around 75–80% of overall U.S.-China high tech trade. (There are over 30 4-digit HS codes that are classified as "high-tech" by AeA, and are available from AeA or USITO upon request.

CONCLUSION

We look forward to working with this Commission, the Congress, and the Administration to ensure that China's historic entry to the WTO benefits American high-tech companies and our 5.3 million American workers. I'd like to thank the Commission again for including me among the participants on this distinguished panel, and I'd be happy to answer any questions.

PANEL II DISCUSSION AND QUESTIONS AND ANSWERS

Co-Chairman MULLOY. Thank you very much.

Commissioner Wessel?

Commissioner WESSEL. Thank you, and I thank the panel for very impressive and knowledgeable presentations. I hope we can call on you over the coming weeks—coming years, since this is a permanent Commission—for your advice and counsel as we move on these issues.

I'd like to understand two things, and Mr. Fielder, maybe you can help me with one, because how trade works with China is often a function, I guess, of individual relationships, and entry into the WTO will not necessarily change dramatically the way that one does business.

How do the princelings work into this situation? How should we be viewing them? And as you know, the role of this Commission is fairly broad—security, encompassing both economic as well as traditional security issues.

Mr. FIEDLER. By "princelings," I assume you mean the children of high-level Chinese Government officials.

Commissioner WESSEL. Yes.

Mr. FIEDLER. For example—this is my common knowledge here—an example would be Jiang Zemin's son, who is the alleged gatekeeper for IT in Shanghai. How would that affect business? Theoretically, the way the system works, if business is directed to those companies that might be headed by princelings, and if you didn't like the deal, you were unable to negotiate with such people, maybe you wouldn't be able to do business.

The princeling relationship is to be subsumed within the overall "guangxi" relationship. It just happens to be a slightly more powerful and insidious aspect of the guangxi. It's hard to do business is the answer to that.

Commissioner WESSEL. To what extent do we have knowledge of the princelings here in the U.S.—and this goes not only to the economics but again to the broader security issues and what role they are playing there.

Mr. FIEDLER. I think there is very little public knowledge about the role of princelings in the United States and Chinese business in the United States and their relationships with U.S. corporations.

I think there is probably plenty of knowledge about that within the United States Government.

Commissioner WALDRON. Could I just come in on that point, this very specific point. It is my understanding that the intelligence agencies have on occasion been asked to gather information about the personal relationships in the Chinese leadership—father, son, who are the nephews, where do they live, and so forth and so on—and that this has consistently not been done. In other words, it might seem logical that, for instance, the Central Intelligence Agency would have a very, very good grip on all of these connections and who is related to whom, and who had a false name and so forth—but the fact of the matter is that this is an area that has been systematically ignored.

Mr. FIEDLER. Just to quickly answer your question, I think that this knowledge on a finite number of top leaders is probably there. I think if you are talking about who the Shanghai Public Security Bureau chief's son is and what he is doing in Florida, they might not know that.

Commissioner WALDRON. Well, my understanding is that for whatever reason, this particular question, which goes right to the heart of whether we are dealing here with a system of laws or a system of men, has been systematically ignored and that people have been instructed not to pursue this; and in fact we do not have the kind of information which I think Mr. Fiedler quite reasonably assumes we should have. As I understand it, we don't have that information.

Commissioner WESSEL. If I could reclaim my time since it is short, number one——

Commissioner WALDRON. I beg your pardon.

Commissioner WESSEL. No, no, no; I appreciate it. This is an important area, and I would hope that we would find the resources to deal with whatever agencies are appropriate to get some more information on this and those relationships

Mr. Stewart, if I could, since I know you are an expert on safeguards and that area, and our Administration constantly points to the rights that we will have if we find ourselves at risk after WTO accession—what is your view in terms of where we are in terms of safeguards? Is there great utility to them? Are there changes that we should be making—for example, private right of action and an umber of other things have been brought up in the past—that might ensure that U.S. interest are being enforced?

Mr. STEWART. There are two aspects, Commissioner. One is the normal Article 19 safeguard, which a number of industries, most recently steel, have been using here in the United States, which goes against imports from all countries.

The statement from the first panel was that we have a period of time, 12 years, during which there will be a special China-only safeguard which is designed essentially to take Section 406 of the Trade Act of 1974 and make it a temporary law vis-a-vis China (19 USC 2451).

The fact of the matter is that 406 has historically been used less than a dozen times in the 28 years that it has been in place, even though it has a much lower standard than 201 does, and the special safeguard right that we have vis-a-vis China could be a very powerful tool on the import side, where industries face surging products.

If you take a look at Chinese exports to the United States, there are literally hundreds or even thousands of HS numbers where there have been really very dramatic increases in exports from China, many of which theoretically could be subject to that provision. Because ultimately, it is subject to Presidential review and approval, historically, it has not been an effective tool. Whether it will be effective in this interim period really depends, I think, on how the ITC implements the change and how the Administration chooses to act when cases are brought.

To give you a comparison, if you look at global trade flows and you look at our major trading partners, it is only the United States that has major trade deficits with China. Countries that are much closer geographically and regions that are much closer geographically have somehow managed to find ways to keep trade flows more in balance than the United States such as Japan and Europe. And if you take a look at Annex 7, which shows some of the non-WTO-consistent measures that have been used, Europe has used a lot to protect their national interest. New Section 421 and the resulting provision in the agreement is one that could be used for the import-sensitive sectors here in the United States.

Co-Chairman MULLOY. A point of clarification, and then we'll move on. Europe is running a rather large trade deficit with the PRC, from my understanding, over $30 billion, and moving up fast.

Mr. STEWART. I will go back and find that and supply the numbers. I may be looking at historical data, Commissioner Mulloy.

Co-Chairman MULLOY. Thank you.

Commissioner Robinson?

Commissioner ROBINSON. Thank you, Mr. Chairman.

I would first like to commend the testimony of you, Mr. Fiedler. I read your written statement with great interest. I think it is a courageous statement that runs against the grain of a vast majority of the trade and business community, but I believe in balance, it is true and represents an effort to defend largely powerless workers within China and those advocating genuine democracy. So I thank you for that.

On the matter of social unrest, you have indicated that the incidence of labor-related upheavals and riots are on the rise; I would understand that a good deal of the problem is the restructuring—a polite term—of the state-owned enterprises and the fact that it is causing tens of thousands of workers to be separated from their jobs with little, if anything, in the way of severance packages, not to mention retraining and placement.

If this is your view, and if this is an accurate description, how widespread do you think that labor unrest, even of the violent variety, could spread or become within China and what might be the consequences for Communist rule there over, say, the next 5 years? And Mr. Stewart and other panelists, if you have a view on that subject, I would be interested, of course.

Mr. FIEDLER. Let me first say that the issue of unrest is more complicated than simply workers losing their jobs at state enterprises. Before they finally lose their jobs, it may be months and months and months, in some cases years, that they were not paid in the first instance.

The issue of corruption is intricately woven within the problem, i.e., the reason they weren't paid was because the plant manager, who happened to be the party head as well, ripped off all the money.

Part of the same problem is that the banking system is undermined because for years and years and years, it has been making bad loans to these enterprises.

So when you talk about social unrest— for instance, if you fixed the banks and said don't loan to failing enterprises, the state companies would go out of business. There is a lot of ripple and multiplier effects here that make it very complicated. By the way, the complications are what creates the fear among the party. They can keep workers down, if that were the only issue, as long as there weren't tens of thousands of them at the same time—which is why the Chinese Government allows a lot of these demonstrations—and there are thousands; they are daily occurrences, they are just not on U.S. television. And they let them go on until they get out of hand, because they know that the grievances are legitimate.

I think that the party is very frightened about this. I think that even people whom you referred to that I somehow have a view that is different from other people—I don't think so. I only articulate it. They don't want to articulate the view.

A lot of the analysts understand that this is the most serious problem. For instance, if you were to ask any U.S. Government official who was familiar with China what would be the impact of the establishment of independent trade unions in China, they would say the overthrow of the government. And why is that? That is because the party would no longer control what it came into existence to represent—workers. And if the party gave up control of workers, the party might have to give up control of this and control of that and control of something else.

So control in China is a very, very delicate thing, and in fact, I would argue that nobody is in control of much, and you have a group of leaders coming in that Dr. Pearson referred to who are relatively unknown as personalities to the people and have no track record, and they have the burden, in my view, of having to comply with the WTO and consolidate their own power.

This is a very volatile situation.

Commissioner ROBINSON. Thank you.

Ms. PEARSON. If I could add——

Co-Chairman MULLOY. Yes, quickly, and then we'll have to move on.

Ms. PEARSON. Very quickly, it is a volatile situation, very much. I think the interesting thing also to note about it, though, is that it is not a static form of control. The Chinese Government knows it has to wrestle with it, hence we see again and again and again anti-corruption campaigns, many of which have been ineffectual. But it is clearly a leadership that is thinking, starting with Mr. Fiedler's first premise, hard about how to maintain its own rule, but it knows that in order to do so, it will need to change, and the question is will the things that it does in order to maintain its rule for this panel's purpose be helpful to WTO or hinder it. And that is an important question, and I don't think the answer is obvious.

Commissioner ROBINSON. Thank you, Mr. Chairman.

Co-Chairman MULLOY. Vice Chairman Ledeen?

Vice Chairman LEDEEN. First, a quick question for the whole panel. How secure do you think Chinese leadership thinks of itself? I will give you two sides to that. One of the things that has interested us, quietly rather than publicly because there are no data, is the widespread actions by high-ranking families in China to buy second homes in the United States, which looked to some of us not like investments in American real estate but safe havens if things go badly.

Some of the things that Professor Pearson and Mr. Fiedler just talked about suggest that they are concerned about their future, so in other words, it is not a regime that sees itself as the fulfillment of world's historical forces and is going to remain in power until this revolutionary model sweeps mankind.

How would you evaluate their view of their own stability right now?

Ms. Pearson?

Ms. PEARSON. I think that they think a lot about it. I think that it is not a fear of the "quaking-in-my-boots-at-every-moment" type, because they have enormous management problems day-to-day. But I think, from my understanding, probably the top topic on leaders' minds is how are we going to change this party and change this system so that we are able to deliver the economic goods that we need in order to keep this party in power and make it less corrupt so that we can stay in power. And there is a whole——

Vice Chairman LEDEEN. So you disagree with Mr. Fiedler, because he thinks that the main question is not how are we going to change the party but how are we going to preserve the party.

Ms. PEARSON. I don't know that he has spoken precisely to that.

Mr. FIEDLER. I don't think it's a big disagreement.

Ms. PEARSON. No. There is a range of discussion within the party about how you need to do that and the steps that need to be taken, and if it is of use, that can be gone into in greater detail. But I think there is a lot of thought about it in the sense that this is a reason we need to reform; we can't let things get out of hand; we do have to worry about unrest, particularly because there is a very strong feeling on the part of many Chinese urban citizens that the biggest fear in their minds is also social unrest—how are we going to control it if things get out of hand.

Commissioner WALDRON. Could I just jump in as a point of information here, which is that I believe there is a report—it has been in the press—I think it is the Chinese Academy of Social Sciences—which goes into this issue in some detail and has a lot of statistics. One of them that I remember is that 50 percent of all transactions in China are considered to be corrupt or false. It is very comprehensive, and it is quite pessimistic.

I would just like to request that the Commission see if staff can track that down—I can look in my files—but track down that report and get it for us in English.

Commissioner DREYER. There is the Hu Angong report.

Commissioner WALDRON. Is it that report, or—there is another report—the committee report.

Mr. FIEDLER. Let me just briefly address the point. I think the Chinese leadership is considerably worried about the preservation and the maintenance of power.

I also think there is a big difference between what we read in Tiananmen papers about the elders and their fear of loss of power and taking dramatic repressive action to be contrasted with the new, younger leadership that tends to believe that the party can preserve power by reforming.

The question becomes whether the two can be done on a time schedule that does not result in massive eruptions of people. And this is not something that somebody can go to graduate school to decide how to manage.

Vice Chairman LEDEEN. Right. Professor Clarke?

Mr. CLARKE. I only want to add one thing to what has already been said, which is that there is one thing that we sometimes tend to forget, which is that we tend to think when we see any report of unrest or, for example, the Academy of Social Sciences report referred to by Professor Waldron, that if this is something that the government allowed to be published, then things are probably not only as bad, but even worse.

One thing to keep in mind is that the government actually in a strange way does have an interest in spreading these reports of unrest, because that reinforces their claim to be the only force that can save China. If everybody in China felt that everything was hunky-dory, people would be perfectly willing to say "Let's ditch the Communist Party."

Vice Chairman LEDEEN. Yes, that's a good point.

Mr. CLARKE. But many people who don't like the Communist Party at all, you can hear them saying, "Well, it's all we have." And of course, the reason that it is all China has is because they have systematically suppressed every other option. Nevertheless, reports of unrest in a strange way still serve the Communist Party.

Vice Chairman LEDEEN. Mr. Stewart, Mr. Brody, do you have something to add to this?

Mr. STEWART. I would only add that self-preservation tends to be a political mandate in many countries. It is presumably not limited to China.

Mr. FIEDLER. Yes, but the willingness to take repressive action differs greatly.

Mr. STEWART. My point was going to be that if you look at WTO accession and things that are agreed to, it is not uncommon for things to be left off the table where the government feels that they are too sensitive. So there are parts of the accession package that leave elements of agriculture out of the liberalization——

Vice Chairman LEDEEN. My question was about the self-confidence of the government.

Mr. STEWART. I don't have anything on that.

Mr. BRODY. Without speaking to the highest leadership at the ministerial level, mid-level bureaucrats I know have a high level of insecurity about their jobs, because quite a few of them have been laid off in the last 3 years.

When Zhu Rongji came to power in 1998, one of his biggest initiatives, one of this three major initiatives, was downsizing government, and we have seen a lot of ministries disappear or become much, much smaller.

So the government officials that I deal with on a daily basis, yes, they are quite concerned about their positions because they know that they need to—I would just note that Professor Clarke indicated in his testimony that there are elements of Chinese society, especially law professors, who are happy that WTO will bring much more limited government and much more transparency in government actions. So I think that is a positive move.

Co-Chairman MULLOY. Commissioner Lewis?

Commissioner LEWIS. Mr. Fiedler, I was really interested in your views as to why the Chinese wanted to enter the WTO and why we wanted them to. When we were in China in November, we actually spoke with some people who were quite critical of the government, and they did this openly. They obviously had some support up above, and they were critical of joining the WTO because they were concerned, as you indicated, about the unemployment that will occur and what will occur to the peasants.

But the reason that we were told China wanted to enter the WTO was that this was one of the few ways that the leadership, Jiang Zemin and the second person, could actually get some kind of change in the way the Chinese are doing business, and they were trying to modernize the system, and if they just had an edict saying "Do this," it wouldn't work, but if it were a competitive situation, that might force the Chinese businesses to do this.

And as far as why do we want them to enter the WTO, it is obviously for transparency and for rule-based laws and bringing the rule of law to China.

I would like your reaction to that.

Mr. FIEDLER. So in other words, you are saying that the Chinese Government used the foreigners——

Commissioner LEWIS. Yes, that's exactly right—also because they want to keep improving the standard of living of the Chinese.

Mr. FIEDLER. I agree, I agree. They needed an outside reason or rationalization to help, and they cover it by saying they want to have standing in the international community.

Commissioner LEWIS. Yes. That's what we were told.

Mr. FIEDLER. Okay. But let's take——

Commissioner LEWIS. You said it was to preserve the party.

Mr. FIEDLER. Oh, of course—what are they going to tell you? They don't articulate that. They wouldn't tell anybody that. Do you disagree with that? I mean, they don't talk about their party——

Commissioner LEWIS. The preservation of the party would be the result of that.

Mr. FIEDLER. Well, I think it's still the motivating factor, and the fact that they don't tell us that doesn't mean anything.

Minister Long, who was their negotiator for WTO, I spent 3 days with him sitting next to me, and I asked him, "Why do you want to go into WTO? Let me see if I can understand something. You can export pretty much what you want to the United States—that consumes about 40 percent of all your exports—and pretty much what you want to Europe, and you are the largest recipient of investment capital in the world as a growing nation. Why do you want to mess it up by coming into the WTO?"

He didn't want to answer me. That's why I believe in the end this is a stability question, a power question—and yes, sure, lots of people would make money, but let's not get confused about the details of compliance, the details of rules. What is the real reason? The real reason is they believe they can maintain power and stability using the WTO to do it. I actually just think they are wrong. I think it is going to cause more unrest than they can deal with.

Commissioner LEWIS. Well, they were also saying the reason they didn't want labor unions was the same thing that frightens them about the Falun Gong—that 18,000 people showed up one day, and there was a structure and an organization that they didn't control.

Mr. FIEDLER. Look, they don't want labor unions for the same reason Motorola doesn't want labor unions in the United States. That's not hard to understand. Not a lot of people want workers to have representation if they are trying to maximize their profit. That is why it is constant fight in one country after another.

Commissioner LEWIS. And it seems to me that it is in the United States' interest to try to get labor unions in other countries, because this will create a strong middle class in the other countries which will enable them to buy our goods.

Mr. FIEDLER. Well, the whole question of buying goods—we talk about large numbers of Chinese people—the problem is that not many of them have much money to buy much of anything.

Commissioner LEWIS. But Korea is an example of where you have strong labor unions, and they are not running that much of a surplus with us because they do have a strong middle class——

Mr. FIEDLER. You do now, because the Korean labor movement grew out of great struggles where workers were immolating themselves in the seventies.

Commissioner LEWIS. Yes, but they do have a strong labor union and a strong middle class and a strong economy.

Mr. FIEDLER. That's correct, absolutely correct.

Commissioner LEWIS. I'd like your reaction to that, Professor Clarke.

Mr. CLARKE. Well, I agree completely with Mr. Fiedler that China's leadership wanted to join the WTO because they felt it was not only to the benefit of China as a country but also to the benefit of the Communist Party as an institution; but then the question is why. If we are going to say that WTO membership is necessary to save the Party, it must be doing something different for China that not being in the WTO would not do. And as Mr. Fiedler pointed out, it doesn't do very much different for China in terms of its exports. If you just take the U.S.-China bilateral agreement, the U.S. really didn't agree to do anything that it wasn't already going. In fact, China agreed to do a few things that it hadn't agreed to before—for example, to allow nonmarket economy methodology in anti-dumping, to allow this special deal on safeguards where the U.S. can impose these safeguards just on Chinese products for another 12 years.

So it doesn't change that much in China's export picture, so to say that WTO membership changes something about China must mean, therefore, that it is changing something about either China's import picture or its domestic restructuring or something like that. So——

Commissioner LEWIS. As Japanese imports made our car industry more efficient, we were told that the export of American goods to China would make the Chinese industries more efficient.

Co-Chairman MULLOY. Because we are facing such a short time frame, we are going to have to move it, because we have a business meeting that we have got to conduct.

Thank you, Commissioner Lewis.

Commissioner LEWIS. Thank you, Mr. Fiedler.

Co-Chairman MULLOY. Chairman D'Amato?

Chairman D'AMATO. I'm going to be very quick. I think it is very interesting the way you pose this reformer's historic bet, or so-called historic reformers bet. They can take the fruits of modernization and globalization and all the rest, while at the same time, maintaining order and stability, maintaining a Leninist—or whatever you called the control of this party. It is kind of a bet that it is good for us to take them up on in terms of the rule of law and the connection with WTO.

What I am going to suggest and ask you, Mr. Fielder and Professor Pearson, if you would, in that you participated both in that Council on Foreign Relations task force and have some very interesting comments on this—I would like to know if you would put together what you believe would constitute an aggressive structure of technical assistance by this government to attempt to get as much of a promotion of the rule of law through WTO, and of course, that would affect their legal system.

What kind of structure, what kind of technical assistance can we provide the Chinese Government to really move the ball down the road in terms of rule of law through the mechanism of WTO? That would be my suggestion. I think that would be of interest to everybody. So if you all could put that together, having served together on that task force, we would be very interested in that.

Mr. FIEDLER. With all due respect, I would respectfully decline to do that—not because I am particularly incompetent to do it, but rather, I don't believe that helping the Chinese establish the rule of law in WTO compliance is a priority worthy of my effort before they establish the rule of law for the existence of trade unions. It is just something that I cannot abide.

Chairman D'AMATO. To tell you the truth, Professor Clarke, the first time I met——

Mr. FIEDLER. I understand; it's a personal thing.

Chairman D'AMATO. —you, I think we were in Beijing, and you were there with Dan Price, with Phoebe Yang right?

Mr. CLARKE. Yes, that's right.

Chairman D'AMATO. And you were over there, looking at that particular type of project, is my understanding.

Mr. CLARKE. Yes.

Chairman D'AMATO. So maybe that is something that you and Professor Pearson together could help us think through, since I know you have done a lot of spade work in that area.

We are going to give you a pass on that. I think the rule of law gets to your prospect, too, eventually—maybe it's too circuitous.

Ms. PEARSON. The other way the rule of law programs would do that and an important aspect of I think would be to try to foster what another panelist mentioned, and that is the homegrown use of these dispute resolution mechanisms in courts.

Looking at particularly the experience of South Korea, what has led to the strongest, most robust development of laws there concerning IPR particularly has been through South Korean business people suing South Korean business people in courts to try to develop that and create a strong system. So I would see an important part of looking at technical assistance as one of how you foster it internally, because always fostering things internally rather than imposing them externally is going to be the longest-term, strongest way to go in my view. I would be happy to look at that.

Co-Chairman MULLOY. Commissioner Bryen?

Commissioner BRYEN. Thank you.

I want to come back to the trade deficit and WTO. This morning, before the earlier panel, we discussed the fact that one of the consequences of China joining WTO in terms of the United States is that the trade deficit is going to get bigger, not smaller, and there was no disagreement with that.

It seems to me that one of the things we are doing here is we are supporting the Chinese regime with our trade deficit, and I imagine it is going to get worse. Is there a point you reach where we can no longer do that? I would like to ask particularly Mr. Fiedler because of his labor union background. I just wonder how George Meany and others would feel about China anyway.

Mr. FIEDLER. I think we reached that point a long time ago. As a trade union movement, we are not interested in supporting the party, and we are not interested in an increasing trade deficit.

I think in simple terms—and I have stated this many times where people have attacked us as being protectionist—the American labor movement would have supported all kinds of trade agreements with China premised on the following notion: If China would allow the existence of trade unions, fine.

Commissioner LEWIS. Free trade unions.

Mr. FIEDLER. Free trade unions.

There are trade unions all over the world at varying degrees of effectiveness. We trade with the Philippines. They don't have a strong labor movement, but they have a vibrant one.

So it is a principled thing here. The whole deficit thing, I'm sorry, is largely rhetorical. It has been used politically to pass it. All you have to do is look at the lines. The spread is huge. The effect on American workers—the argument we hear is that all the jobs went to Taiwan, and then the Taiwanese lost that. If I listen to these arguments, I don't know that we ever had any jobs in America to lose.

So there is a lot of misinformation that is all over these arguments on numbers and deficits. The real question in the end is what is the political level of tolerance. You were starting to get that this morning. I don't know what the numerical level is, and I don't know what the political level is, but I know there is a limit.

Commissioner BRYEN. I didn't detect that that was a priority of anyone. In other words, the sense I got was that, well, we are going to work on WTO compliance, we are going to work on the trade relationship—but when you started to talk about are you going to turn the deficit around, are you thinking in those terms——

Mr. FIEDLER. Look, they are worried about it. What you saw this morning was that nobody—I mean, they were all bright enough not to make a prediction. They don't have to make the predictions yet, because all the legislation has passed.

Commissioner BRYEN. Right. Thank you.

Co-Chairman MULLOY. Commissioner Becker?

Commissioner BECKER. In the essence of time, I'll keep my remarks, comments, questions very short.

Again, I would like to add with the other commissioners here my appreciation for the testimony that has been offered here.

The preservation is not only for leaders of parties or leaders of countries; it is also, as I view it, preservation for workers and their way of life, values that we hold near and dear, and they have been touched in many ways here in the United States.

But to try to bring this in focus a little bit, I have read recently that by the year 2010, China will be the largest manufacturing entity in the world. We are hearing projections now and complaints from other nations—Taiwan, about the hollowing out of their manufacturing base, that everything is going to China. We are hearing this from Japan about the hollowing out of manufacturing in Japan; it is going to China. We are hearing it here in the United States about the hollowing out of our core industries in the United States; it is going to China.

We have lost core industries in the United States. They have been virtually dismantled, with investment opportunities moving into China and exporting back into the United States. Some of them are very basic industries, but the majority of them—and I am talking about basic industries like steel and auto and textiles, but a lot of them are just manufacturing entities, small ones, that can't take advantage of the trade laws in the United States, that cannot file 201 cases, like bicycle manufacturers, mom-and-pop shops that support a small handful of people. They don't have the resources to be able to process trade cases and pursue them. But this has happened time and again here in the United States.

I listened to Mr. Brody project about the tremendous increase that is expected to take place in high-tech equipment by the end of this next year and as follows—and that's good—that's jobs in the United States.

But I would be interested in any comments that you have on what you see for manufacturing hands-on workers in the United States under the WTO arrangements now with China. Is there going to be an increase of exports from the United States in these areas? Are we going to be able to compete in any form? When you look at the wages, when you look at the repression of workers, when you look at the human rights or whatever, are we going to be able to compete and increase our exports in the jobs that are important here in the United States to maintain a middle class here? What do you see for the future?

Mr. BRODY. Well, to be able to speak to the hollowing out of the Japanese, Korean, and Taiwanese industrial sectors would perhaps be a bit closer to home, considering that I live in Beijing. It is difficult for me to make predictions about the U.S. manufacturing sector, but I do know that the Chinese customs, tariffs, in the past, along with many other soft obligations in terms of JV requirements, tech transfer requirements, et cetera, created a pressure for foreign companies to establish joint ventures and to conduct some form of assembly and/or value-add production in China, if not everything, then at least some sort of processing trade.

With the dismantling of these soft barriers, and notably dismantling of import tariffs, this will allow products that are manufactured anywhere in the world to enter tariff-free, which means that the WTO agreement removes many of the hard and soft barriers to a product coming in from the outside, which means there is less incentive to move the manufacturing there. Of course, there are still economies of scale in being close to your customer.

Mr. FIEDLER. I don't think there is going to be much positive effect upon U.S. manufacturing. We are not going to sell them cars; we are going to sell them some more airplanes, Boeing will. But we will sell them a bunch of capital equipment—in other words, machines to make things to compete against us. That will be a short-term thing.

What you see, George, is that manufacturing is moving there. This gets to the question of whether the WTO agreement is an investment agreement or a trade agreement. The greatest effect is on U.S. companies' ability to invest, and I guess if you argue that their shareholders will make a little more money because they can sell stuff cheaper to other places around the world, and the trickledown effect of that, unless you are a shareholder of Enron, is somewhat positive—but there won't be jobs.

Commissioner BECKER. WTO was sold in the United States——

Mr. FIEDLER. As a trade agreement.

Commissioner BECKER. —on the basis of creating jobs in this country. This was what the leaders of our country did. Do you see that at all?

Mr. FIEDLER. No. They just used it to sell it. It sounded good.

Co-Chairman MULLOY. Commissioner Becker, we have really got to move because we have a business meeting.

Commissioner BECKER. We had a hand up over here. Could we just hear from him?

Co-Chairman MULLOY. Yes.

Mr. BRODY. I just wanted to comment that recent reports from China——

Commissioner BECKER. No, no. We had a hand up from Mr. Stewart. You already made a comment.

Mr. BRODY. I'm sorry.

Commissioner BECKER. Time permitting, we can go back.

Mr. STEWART. Mr. Becker, the one area from the Commission's point of view that you may wish to look at is the extent to which the coverage by the state of operating losses for the state-owned enterprises is in fact carried out. It is one of those areas that would hold out some hope for manufacturing because part of the artificial price advantage is the huge operating losses in basic industries that are picked up by the State through State transfers. So that is an area where if, in fact, China lived up to its obligations, there could be some hope.

Co-Chairman MULLOY. Thank you. That is a subsidies issue, then, and the safeguards would get into that.

Commissioner Waldron?

Commissioner WALDRON. I just wanted to come back just very briefly to two questions with which we began. One of them was the issue of saving the party, and the other was why did they join the WTO.

I'll just give my opinions, and if anybody wants to comment, they are welcome to do so. I think that the Chinese joined WTO because their regime now fundamentally rests its legitimacy on foreign money and foreign political approval. In other words, although they worry about the state of opinion within China, like previous Chinese regimes, they feel that every opportunity they have to present themselves as a legitimate and accepted member of the international community makes it that much easier for them to then go to their own people and say, “See—we are in the UN, we have the Olympics, we are in the WTO, we are in APEC.” I mean, the President of the United States seems to think that Jiang Zemin is the legitimate leader of China. So if an American thinks that he is the leader, well, surely you should all agree that he is the leader.

The other point is that it is better for them to be inside the tent than outside. You see this, for instance, in the negotiations over the South China Sea, where the role of the Chinese delegation has been to torpedo every agreement that threatened to actually begin to move toward some kind of demilitarization and resolution there. I am not sure exactly how that would operate in the WTO, but if there is going to be an international organization, the Chinese want to be in it, partly so they will be able to exercise some control and partly so they will be able to put it as a sort of signifier of international acceptance on the wall.

On the issue of unrest, I think this is something that—as pointed out, it is not on television, but it is very important. However, although we have been taught for 100 years or more that revolutions start from below, when the masses get angry, and they finally march out of the factory, and they join, and all the rest.

There is the People’s Armed Police, and although I’m not sure the PLA would shoot their own people again, the People’s Armed Police is a very unknown quantity. I have had some dealings with them, and I’ll just sum it up by saying that they drink heavily at lunch.

And that is a serious point. They are not a disciplined, well-organized, reliable police force at all. But in fact, the way you get unrest in China is when you get disagreement at the top, when you get elite disagreement. And one thing that I think is very concerning now is that first of all, whatever happens, the next generation of leaders will be young—youngish—they are going to be unknown, they are going to have no personal clout based on their own guangxi networks, and so forth. That is the first thing. Therefore, it is going to be very hard—if you get a phone call from one of these new guys, you are not going to quake in your boots, whereas if you got a phone call from Deng Xiaoping, you were scared out of your wits.

The second thing is that we already know that there are a lot of disagreements at the high levels in China about a whole variety of issues of which WTO is one. And what has traditionally happened when you look at it in the last 100 years of Chinese history ever since the succession system of the monarchy was abolished is that trouble starts when two guys at the top disagree about who should be in charge. So far, that hasn’t happened, largely because there have been certain individuals who have been strong enough simply to assert things. But we are now moving into a situation where I think that could happen, and if that sort of disagreement at the top began to link up with the social tensions down below, we would really have—I think there would really be trouble.

This doesn't directly bear on what we are saying, but I think that when you consider the Chinese future, this is probably a more likely future than is the implicit future on which most of our policy rests, which I think Mr. Fiedler made very clear—it is this idea of stability at all costs.

I am always reminded of what happened when the Soviet Union began to come apart. Instead of seeing that this was the obvious product of decades of misrule and misallocation of resources and oppression—and it was bound to happen and was irreversible—the American diplomats were all caught flat-footed and didn't even know what to do, and poor, old President Bush, Senior went and made his famous "chicken Kiev" speech, sort of saying, please, for God's sake, stay stable.

The way China is going to become stable is for genuine reform which gives its people citizenship, participation, and rights such as labor union rights and others. That's the only way you're going to get stability. This other way is only going to lead to instability, and the idea that there is some way that you can square the circle in China where you can't do it elsewhere is just a mirage. I think it is very important to bear this in mind as we look at the current situation.

Thank you.

Co-Chairman MULLOY. Thank you.

I haven't asked a question, so I have a quick one. Whether the group that is in charge wants to survive, my impression was that they have tried a lot of different kinds of ways to get ahead in China, after a long period of humiliation, a great civilization—Mr. Overholt is going to talk about that later today—and they tried different ways to organize themselves to get back to where they were, as a very premier civilization, and some of the reforms now to get the technology, to get the economic growth, to get the investment that they need, and this is part of what they are really doing, and it may keep them in power, but it also serves what they perceive as the long-term interest of the country.

Mr. Clarke, does that ring true to you?

Mr. CLARKE. That's essentially the point I was trying to make a few minutes ago—that is, while there is no question that the priority for this regime is staying in power, I believe that they think that the reforms called for, reforms that they have already undertaken—and I want to repeat that WTO membership is really a subset of a larger reform project—I think they do see that as the only way forward.

Co-Chairman MULLOY. Yes. That fits in with the point that the WTO agreement was more an investment agreement than a trade agreement.

Mr. FIEDLER. I don't disagree with you. I only say that that is insufficient, that economic reform is insufficient. Political reform is necessary—and by the way, capitalism doesn't build democracy, it doesn't build civil society, it doesn't do any of this other stuff.

Co-Chairman MULLOY. The handle is, though, that somehow or other, the economic reform is also going to bring some political reform.

Mr. FIEDLER. Yes, but the question is the pace and what happens—does something get ignited before the nexus 300 years out is there.

Co-Chairman MULLOY. Does anyone have a final comment? Otherwise, we're going to finish this up.

Anyone?

[No response.]

I want to thank you all so much for being here. You have helped us, and I hope we can stay in touch to get your continuing help, and particularly Professor Clarke and Professor Pearson on that issue that Chairman D'Amato asked you to focus on.

Thank you very much.

(AFTERNOON SESSION, 1:10 P.M., FRIDAY, JANUARY 18, 2002)

PANEL III: FINANCIAL SERVICES

Chairman D'AMATO. The Commission will come to order.

This morning's discussion laid out the significant hurdles that China faces in implementing its WTO obligations. Whether China can successfully overcome these hurdles and how long this process may take is an issue that will underlie the U.S.-China relationship for years to come.

As part of its assessment of the implications of China's WTO accession on U.S. national security, the Commission has sought out testimony from representatives of impacted United States industry sectors.

In prior hearings, we have heard from the steel, aerospace, automotive, agriculture, and electronics industries. Today we will hear from three additional sectors, all of which supported China's accession—financial services, entertainment, and communications. They will enlighten the Commission on both the potential business opportunities they foresee in post-WTO China and the obstacles they face in achieving this potential.

Our first panel of the afternoon will examine the prospects for financial services firms in China; they will be followed by a panel focusing on the entertainment industry and protection of intellectual property rights in China; and finally, we will conclude with a panel discussing the unique challenges facing communications firms seeking to operate in China, particularly the censorship and other content restrictions imposed by the Chinese Government.

With today's hearing on export controls and today's discussion of WTO issues, the Commission has completed 10 hearings evenly split between trade and investment and security issues.

The Commission has no other public hearings presently scheduled during our initial reporting cycle, which concludes with the issuance of our first report to the Congress in June of this year. We will, of course, continue to seek input from relevant government, academic, and private sector individuals where needed to assist us in preparing our report.

I would now like to turn to our first panel of the afternoon. The U.S. financial services industry, including banking, insurance, and financial securities firms, strongly supported China's accession to the WTO. China's WTO agreement promises to open up China to foreign financial services firms which heretofore have been denied any real access.

While significant restrictions will still apply—for example, foreign insurance firms will be limited to 50 percent ownership in life insurance ventures, and foreign securities firms will only be allowed to participate as minority joint venture partners—China nonetheless presents vast new opportunities for U.S. financial services firms.

However, China's banking sector is presently dominated by state-owned institutions that have amassed high levels of bad debt from years of making loans, often at the direction of the Chinese Government, to failing state-owned enterprises or SOEs. Whether the Chinese Government is prepared to introduce foreign competition for these institutions and the consequences if they do are important questions that I know this panel is going to address.

We are pleased to have with us today a distinguished panel of experts on China's financial services market—David Hale, Global Chief Economist for Zurich Financial Services, who was kind enough to come from Chicago and who testified before our prior Commission on the Trade Deficit Review Commission. He also represents one-half of a unique partnership, and it is the first time we have had a husband and wife team testify before this Commission. His wife will be testifying on the third panel this afternoon.

We also have William Overholt, Senior Fellow at the Harvard University Asia Center, who has just come from Hong Kong as an international banker in Singapore; and Mr. Andrew Shoyer, a partner with Powell, Goldstein, Frazer & Murphy, who served for several years in legal advisor positions at the Office of the United States Trade Representative.

I think what we will do is go from left to right, starting with Mr. Overholt. We have a system here where you get a period of time to make your remarks. While the light is green, you are in the safe zone; when it is yellow, think about summarizing; and when it is red, think very hard about summarizing, and we will go to the next witness, and then go to Q and A after all three panelists have given their opening remarks.

Dr. Overholt?

STATEMENT OF WILLIAM H. OVERHOLT, SENIOR FELLOW, HARVARD UNIVERSITY ASIA CENTER

Mr. OVERHOLT. Thank you. I am honored to have the opportunity to address this panel.

I spent the 1970s as a national security consultant and the last two decades mostly in Hong Kong as an investment banker. Since I am now a scholar based at Harvard, I am not representing anybody or any group here.

The greatest contribution of WTO to the financial industry and to just about everything else is a consolidation of China's role as a supporter of the system. Thirty years ago, China was the biggest disrupter of the international political system and the international economic system in our terms. It caused problems for banks, it caused problems for our military, it caused them all over Asia, and it caused them all over the world.

In the meantime, it has gone to saying, well, if you welcome the foreign banks, and you welcome the foreign corporations, and you try hard to play be the rules, you can grow faster than anybody else in the world.

The effort to play by the economic rules of the game has been accompanied by a view that they need stability, political stability, in the region so they can focus on economic development, and that has led them to be very supportive of stability in places like Korea, which is the opposite of what they used to do.

What WTO symbolizes and attempts to consolidate is this change of China's role. On the political side, you have their efforts to stabilize the Korean peninsula; on the economic side, you have WTO.

What this has done is to reduce risk—risk in our business with China, risk in doing business with Asia, risk in doing business just about anywhere in the Third World. It is equivalent to a very substantial reduction of interest rates throughout Asia. It has led to a tremendous expansion of commerce.

China has clearly benefitted. It has had the highest growth rates in the world for a couple of decades as it moved from being the biggest opponent of the system to one of the bigger supporters of the system.

It is for that reason that questions about the sincerity of their interest in joining the system have a positive answer. In fact, China, although it has not been commented on much in the press, has gone far beyond most of its capitalist neighbors in opening its economy. Its trade to GDP ratio is now three times that of Japan. It is more welcoming of foreign investment than anybody else in the Third World—I'm talking in terms of institutional structures and rules—than anybody except Hong Kong, Taiwan, and Singapore.

If you go to any street corner in a Chinese city and look up and down, you will see Jeeps and Buicks and Volkswagens to an extent that you will never see them in Tokyo and Seoul.

If you go through Customs in Beijing, you'll see them just wave 500 or 1,000 people through. It is the only place I know of where they pay less attention to checking you than Hong Kong.

China has become the leader of Asia's efforts to create a real free trade zone. ASEAN got into difficulty and kind of dropped the ball, and China has picked up that ball. What they and the Southeast Asians are trying to create in CAFTA is, as nearly as we can tell, a precise analog of NAFTA. It is very different from the Japanese effort to institutionalize a set of bilateral relationships that would institutionalize agricultural protectionism and various other kinds of protectionism.

The problems we have with China's trade policy and other trade policies are very real, but they have gone an amazing distance. The Chinese leaders' primary motivation is to use us and our lawyers to try to expand the rules of the game within China. They have never had a truly national domestic market for financial or another kind of business, and they figure our lawyers can help them break down the barriers between Sichuan Province and Qinghai Province, and they figure they need a lot of help in that.

China's efforts at financial reform go far beyond anything that we could have expected. Their theory of fixing their banks—and they recognized in the early nineties that they had a crisis—was that you have to fix the banks' customers first, and those are the state enterprises. In the process of trying to fix the customers, they have laid off 47 million people from the state enterprises and about another 8 million from the collective enterprises; done a total reorganization of their banking laws, heavily based on the Taiwan and Hong Kong and British examples; done a total reorganization of their central bank, heavily based on the U.S. Federal Reserve example; and begun selling off bad assets of the banks at discounts up to 80 percent, modeled on the Resolution Trust Corporation of this country—exactly the opposite of the approach that Japan and Taiwan have taken. And following us has meant success for them so far.

As they open their financial system, they fear collapse of their banks, which would bring great social distress if it happened. On the other hand, our banks can be the solution to their biggest problem, which is if you lay off 47 or 55 million people, you have got to create a lot of jobs. Smaller and private companies have to do that; the state enterprise system cannot create jobs. The Chinese banks only know how to lend to the state enterprises. If they start trying to do venture capital, they lack the skills so they are in big trouble. Our banks can teach them how. The South Koreans have been through this and are benefitting. So the hope is that the Chinese go that direction.

Another area which is crucial—and I'll bring this to a close quickly—is in their shift to a domestic-led economy. We started urging this on Japan back in 1979. The Japanese started urging it on themselves in 1986. China decided to do it 4 years ago and did it. As a result, they are growing 7 percent at a time when the rest of the world is in recession and when Chinese net exports are contracting.

What is generating growth for them? Housing, cars, retail sales, infrastructure. These are the areas where our banks can help them. And this is what, (over an historical period, unfortunately,) will eventually shift the trade balance more in our favor.

Finally, the area of greatest difficulty is going to be in the rule of law. The laws are new. The judges don't know the laws. The interpretation of the laws is inconsistent across China. The judges are reappointed based on local politicians' decisions, and the judges frequently cannot enforce their judgments anyway.

Imagine yourself plunked down in Zaire and told that in 5 years, you must create a serious, effective, consistent legal system, and then multiply that task by 30 or 40 or 50. That is the problem that the Chinese have.

The fortunate thing is that they know that the banks are only going to be able to do business if they fix this and to the degree they fix it. So at this level of rule of law—not at the high level but at this level—our interests and theirs are completely consistent.

This is going to be the biggest problem we have with them. It also may be the area of greatest overlap we have with them in basic interests.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF WILLIAM H. OVERHOLT

Thank you for inviting me to testify before this distinguished commission. I am testifying on my own behalf, not as a representative of any employer or interest group.

I spent 21 years as an investment banker, including 16 based in Hong Kong. My experience with China includes extensive consulting on national security issues in the 1970s and my current writing as a scholar based at Harvard University's Asia Center. In 1993 I published a book, *The Rise of China*, arguing that China's economic policies would lead to success whereas Russia's would lead to disaster.

The Importance of China's WTO Membership

China's WTO membership is most important to our country as a Chinese commitment to the stability of the global system that we and our allies have created. Only 25 years ago China was committed to destabilizing the world market system and the world political system. It was working together with groups of other third world countries to transform the world economy in a highly socialist direction, with among many other things tight controls on multinational corporations and all trade in raw materials managed through a vast network of cartels. Above all, the Maoists proclaimed that the world was chaotic and that chaos was good.

Since that time, China has moved virtually to the opposite pole, promoting stability and promoting the market. It is now more receptive to our corporate investments than most of our old capitalist allies. Only Hong Kong, Singapore, and Taiwan are as accepting as China of our corporate presence. Japan, South Korea, Thailand, the Philippines, and Malaysia, together with most Latin American and African countries, are more restrictive. China's change of direction disheartened insurgent movements all over the world. Since most of these movement were Maoist, not Brezhnevist, this was at least as important as the collapse of the old Soviet Union in stabilizing much of the third world. Today, the strongest rhetoric about the dangers posed by Western financiers comes from Kuala Lumpur, not from Beijing.

China's commitment to the system is not merely economic. Like most other Asian countries, China has become convinced that a focus on economic development is the only strategy for restoring pride and prosperity and that regional and global stability are prerequisites of such focus. Through the mid-1970s China was sponsoring guerrilla warfare in every non-communist country in East Asia—and in much of the world. In contrast, today it is on friendly terms with every non-communist country in East Asia. Although half a century ago China was an ally of North Korea's assault on South Korea, for almost two decades it has been (in everything but words) much closer to South Korea than to North. For a quarter century, notwithstanding verbal and tactical differences, China has been more important to us than any other country in assuring stability on the Korean peninsula. Although it wasn't covered entirely accurately in some of our media, President Jiang Zemin was very early and very strong in his denunciation of the September 11 terrorism and in his assurance that we would have China's support against terrorism.

When I returned to Harvard after an absence of 33 years, I was amused to discover that some residual Cambridge Maoists were publishing a newspaper that among other things denounced China for being a capitalist country. The paper was particularly vituperative about the fact that Beijing had supported the Nepalese government's attacks on the Communist Party of Nepal as a necessary measure to prevent terrorism. There are very few Maoists left at Harvard, but there are more of them on the major U.S. campuses than on the major Chinese campuses. This is symptomatic of China's changed role in the world.

Former President Lyndon Johnson once said of a candidate for high office that it would be better to have him inside the tent pissing out than outside the tent pissing in. We have seen China both outside the tent and inside. China outside the tent caused trouble in every corner of the world, from the jungles of Thailand to the diplomacy of Tanzania to the university campuses of the major NATO countries. The whole world is clearly better off with China inside the tent.

The signing of the WTO agreement is the economic counterpart of China's restraint of North Korea, underlining a Chinese belief that its interests are best served by fundamental economic and political stability.

For the financial world, the importance of China's change from revolutionary to conservative policies is a pervasive diminution of risk. Two kinds of risk diminish. First, the likelihood that, under pressure, various countries might use the alleged unfairness of the "imperialist, unequal" global economic system to repudiate debts or to harm foreign investors has declined throughout the third world. Second, there is a vast diminution of specific financial risks to various countries and regimes that are once were systematically undermined by Beijing and now are systematically supported by Beijing.

This diminution of risk is equivalent to an important decline in interest rates, and that decline stimulates business throughout Asia. This is not just a bilateral issue; it is regional and global.

Aside from the general diminution of risk throughout the third world, specific opportunities have arisen from China's evolution from a power that seeks to destroy the system to one that seeks to gain advantage from it. China's trade is now several hundred billion dollars per year, most of which needs to be financed. Foreign direct investment in China now exceeds $40 billion per year, all of which is processed by banks; much of it is venture capital, an area in which U.S. investors excel. China's

WTO accession should be seen as part of this ongoing process, an attempt to consolidate past achievements and an attempt to promote it further.

Consolidation is important; one cannot take past successes completely for granted. One key aspect of consolidating the progress that has been made is reassuring everyone that there is agreement on the basic rules of the game. Given China's history, the public agreement on the basic WTO rules is a dramatic symbol.

There is also a series of efforts to reduce the risks of the game. Here I will mention just two. First, financial agreements sometimes come asunder and when that happens all parties need assurance that problems will be resolved in an orderly way. While China's payment of its sovereign debt has been exemplary, at lower levels there have been problems. The laws have been unclear, the judges have proved erratic, and enforcement of rulings has proved difficult at best. (Arbitration processes have worked much better.) Both sides understand that existing business carries unnecessary risks and new kinds of business are inhibited by the current erratic system. Foreigners and the Chinese leadership are equally anxious to use the WTO process to promote a more effective and predictable legal system.

Second, both foreign investors and the Chinese have been concerned about the unusual degree to which China-based business can be suddenly threatened by political restrictions or by arbitrary protectionist decisions taken by China's trade partners. WTO is expected to reduce the scope for both kinds of problems. All this gradually drains the risk out of business, thereby expanding the volumes and reducing the risk premiums.

The process of reducing these risks is equivalent to another major reduction of interest rates affecting business with China, and the expected consequences are occurring. I quote here one example from a consultant report published while I was writing this testimony: The chemical industry is currently in the midst of a major wave of investments in the billion-dollar-plus category stretching out to 2005, represented by leading companies such as BASF, BP, Bayer, ExxonMobil and Shell.

These mega-projects were justified based on a perception of reduced risk—directly affecting the shareholder value calculation—in which China's political and economic stability and entry into the World Trade Organization were discounted well in advance.

Beyond consolidating the existing business expansion, China's WTO accession should expand and improve business not just with China but also regionally and globally. In the process of becoming a system-supportive power, China has gone well beyond most former members and is now becoming a leader in creating a truly open market economy. Many Americans are surprised to realize how much more open and market-oriented China has become than many of our traditional allies. For instance, trade now is three times the share of GDP in China that it is in Japan. Other indicators such as foreign direct investment provide similar results. China is so welcoming of foreign direct investment (FDI) that it now receives every year more FDI than Japan received in the entire decade of the 1990s. Similarly, the trade regime is more open to foreign goods than those of key capitalist neighbors. Stand on any street corner in a major Chinese city and your will see Buicks, Jeeps, and Volkswagens in profusion—something that has never been true in Tokyo or Seoul.

The benefits that China is receiving from being so welcoming of FDI are beginning to put pressure on the neighbors to become equally welcoming. From Japan and South Korea in the North to Thailand in the south, many Asian countries (not to mention Latin American and African countries) structured their foreign investment rules and institutions in an era of great skepticism about multinational corporations; the result was a strong preference for financing growth primarily through domestic bank debt, and second through foreign bank debt, rather than through foreign investment; Taiwan, Hong Kong, Singapore, and now China proper have been the leaders in overturning this old nationalistic approach, which has slowed growth and led to financial crises for many decades, particularly in Latin America. China's success based on enthusiasm for a more open market will prove seductive to these more restrictive regimes.

China has become a leading advocate of free trade. Having moved so far toward commitment to free trade in its WTO accession agreement, China has little to lose and much to gain from promoting free trade. Since it is the low cost producer in many labor-intensive areas, it sees very direct gains from freer trade. This lies behind China's promotion of CAFTA, an Asian version of NAFTA which appears (on admittedly early indications) to be quite compatible with the principles on which we promoted NAFTA. It is fascinating to watch China and ASEAN promoting real regional free trade agreements while Southeast Asian countries plead with Japan to abandon its contradictory approach of promoting bilateral "free trade agreements" that are actually designed to institutionalize protectionist measures, particularly in agriculture.

Another area in which China has gone to the free market extreme is in the decision to legislate that the WTO accession agreement is takes legal precedence over any domestic law. That kind of priority for international trade and investment rules is unthinkable for most countries, including of course our own.

These Chinese initiatives increasingly put pressure on neighboring countries to follow suit. The pressure comes not from political arm twisting but rather from force of example. This is how Japan led from the 1960s to the 1990s. At that time, Japanese methods led to superior growth, so other countries studied Japanese management and often followed Japanese and Korean examples even when they involved painful reforms. China's achievement of currency stability in an era of devaluation crises, and of 7 percent growth in a time of global recession, are making a big impact on neighboring countries. Likewise, the ability of China, Hong Kong, Japan, South Korea, India and Singapore to make huge gains in foreign direct investment through quite modest efforts to be investor-friendly will undoubtedly drive further improvements throughout Asia and eventually the world.

The greatest expansion of the financial industry in the history of the third world has occurred throughout Asia as an aspect of this broad risk reduction and the general expansion of commerce and investment that has accompanied it.

China's Willingness and Ability to Meet WTO Requirements

The WTO agreements require China to make adjustments that go far beyond anything most other countries would be willing to attempt. Industries that are in a primitive, fragile condition are required to open within five years. In contrast, the normal pattern among OECD countries has been to provide 15 years for far more modest adjustments. The U.S. textile industry has had four decades to adjust to Asian competition and gets another dozen under the WTO agreement with China.

China's financial industry is a case in point. China's four big banks have millions of employees, all of whom lacked any credit training until a few years ago. Throughout most of China's territory, sending somebody a check will simply frustrate the recipient, who is likely to be told, "We don't have the money now. Come back in a few weeks." Even in the big cities, people mostly pay their utility bills in cash. The biggest banks are estimated to have non-performing loans amounting to just under half their assets, yet they are expected to compete in five years with the biggest U.S. and European banks. If someone suggested opening all of Africa's banks to full foreign competition in five years, he or she would probably be derided, but China's banks are probably in worse shape than the typical African banks, and China is the size of many Africas.

On the other hand, there are positive signs.

China's leaders are very serious about confronting their financial problems. Instead of waiting for their country to hit the wall as South Korea, Thailand, and Indonesia did, China's leaders saw the problem coming and took action years before crisis was imminent.

Second, unlike Japan and Taiwan, which have allowed the banks' problems to fester and multiply long after these problems had created a national malaise, China has taken very decisive action. The primary strategy has been: to save the banks, we must fix the banks' customers, which are mostly the state enterprises. In pursuit of that strategy, they have spun off the vast majority of the state enterprises, retaining only the larger ones and imposing drastic reforms on those. In the last few years, the state enterprises have been forced to lay off 47 million people. In a particularly dramatic contrast with Japan, China has begun auctioning off banks' bad assets on the model of our own Resolution Trust Corporation, at discounts that sometimes run 80% of face value.

Unlike most third world countries, China took decisive early action to curtail moral hazard in its dealings with foreign banks. The leadership retracted formal guarantees even from its most prestigious companies, and it allowed the prestigious but mismanaged GITIC to go bankrupt, setting an example that corrupt, mismanaged companies would not be bailed out. GITIC had been the showcase company of China's most successful province. Angry foreign bankers, who expected developing countries to bail out corrupt companies if they were well-connected, deprived China of what would have been tens of billions of dollars of loans. For a while there were questions about the futures of the leaders who made the decision to bankrupt GITIC, but history may well say that that decision made the difference between success and failure for China.

China has also transformed its financial system. To take a few examples: the central bank was separated from commercial banks and made a pure regulator. It was then reorganized along regional lines, modeled on the U.S. Federal Reserve System, in order to make it less vulnerable to local political pressures. The commercial banks were separated from the development bank. The commercial banks have been put under the control of young reformists, who have been provided with incentives for good performance and strong sanctions for poor performance. Disclosure requirements have been continuously raised. In the spring of last year, Bank of China led in opening its books to an extent that would be unthinkable in Japan or Taiwan.

The Chinese banks are creating elite divisions that increasingly can compete with world class foreign competitors in certain areas, even while they struggle to deliver checks in much of China.

The financial dilemma is a microcosm of the larger Chinese system.

The good news is that China works much harder than anyone else at digging itself out of a hole.

The bad news is that the hole is frighteningly deep.

The good news is that the financial markets are very generous with people who are as serious about reform as China clearly is.

The bad news is that there is no margin for error, no willingness to tolerate even a short period of weak management.

The good news is that growth comes from improvement at the margin, from how fast you dig. Since China digs fast, it grows fast.

The bad news is that China has grow fast continuously in order to survive. If you lay off 47 million people, you have to create a lot of jobs and that takes more growth than anyone else in the world can muster these days.

Optimists look at how hard the Chinese work at filling in the hole. Pessimists look at how deep the hole is. Both have plenty of exciting numbers.

The WTO requirements are just one more piece of this larger picture. A David with broken legs is supposed to be ready quickly to fight off Goliath at his peak. A bank with two million employees who have no credit training is supposed to compete with Citigroup in five years.

The risk to China is that the foreign banks come in and take away the best customers, leaving the Chinese banks decapitated.

The opportunity for China is that foreign banks could resolve China's greatest problem, namely the efficient financing of job-creating firms. The problem arises in the following way. In order to avoid a financial catastrophe, China has had to retract bank support from a vast array of state enterprises, leading to loss of 47 million jobs there and another 8 million elsewhere. Having laid off all those people, it desperately needs to create new jobs. Political stability depends on that. The state enterprises will be job shedders for the foreseeable future, so they can't help. But the Chinese banks only know how to lend to the state enterprises. If an institution with limited credit skills starts lending to entrepreneurs on a large scale, the results will be as disastrous as lending to the state enterprises.

Foreign financial institutions are a necessary part of the answer to this dilemma. Foreign venture capitalists, primarily from Taiwan, Hong Kong, and the U.S., will play a big role. Foreign banks will both lend to Chinese companies and teach Chinese banks how to do so without losing their shirts.

Chinese leaders will have to maneuver to prevent the decapitation and collapse of their banking system, and we will undoubtedly see some interesting controversies as they do so. But if they focus on defending their domestic banks, as most politicians in most countries would, then they will risk destabilizing their country for lack of job creation. To stabilize China, they must make pervasive use of foreign banking skills. I am inclined to believe that this will require a much bigger upheaval in the Chinese banking system than has yet been mooted. South Korea provides perhaps the most helpful model for what China needs. In the past four years, the South Korean banking system has been shattered and then sufficiently rebuilt with extensive foreign participation that it is beginning to offer a credible financial foundation for a very prosperous Korean future. This contrast sharply with Taiwan, which four years ago was in much better shape than South Korea, but has been so defensive about its banks that it has fallen behind.

The Key Role of Legal Reform

As foreign financial participation increases, the most intractable problem will probably be China's legal system. Inadequate laws, judicial ignorance of the law, political pressures on judges, and inability to enforce court judgments are pervasive problems. There is almost complete agreement between the Chinese government and foreigners about what needs to be done. The problem is not disagreement in principle but the depth of the hole that China finds itself in.

The bulk of Chinese financial law was written in the last few years. Only last year were judges required to have formal legal training. Most judges are hired by local governments and dependent on them for continued tenure in office; hence, regardless of national policy, they are vulnerable to local political pressure. Different courts in different regions reach contradictory conclusions and there is no satisfactory mechanism for resolving the contradictions. With the best will in the world, Chinese courts have great difficulty persuading anyone to implement their judgments. In financial terms, this creates an insuperably high risk premium on doing business below the top few corporations. To understand the scale of this problem, imagine yourself plunked down in, say, Zaire, with a mandate to make all of Africa's courts consistent and credible within five years. Then imagine having the same job for many Africas simultaneously. That is the dilemma of reforming China's legal system.

Because of the legal and accounting and transparency shortcomings, foreign banks will initially have maximum incentive to concentrate their energies on decapitating their local counterparts. But to the extent the legal and transparency problem can be overcome, vast increases in the size of the credible market and the potential profits will be enormous. On the Chinese side, to the extent financing can be delivered to lower tiers of companies, there will jobs, prosperity, and political stability.

The stakes in this game go far beyond profit margins. Western politicians see WTO not just as a way to increase access to the Chinese market but also as a way of exerting political influence by creating a pervasive commitment to the rule of law. Chinese leaders see exactly the same benefits, and the current generation of leaders is trying to use WTO to lock in its successors.

The Shift to Domestic-Led Growth

About four years ago, China made a deliberate decision to begin shifting from export-led growth to domestic-led growth. Foreign banks may well play a vital role in the continuation of this shift.

Most Asian countries achieved their economic takeoffs by emphasizing export-led growth, but starving the domestic market in order to promote exports eventually has negative consequences. The sources of growth at home become unacceptably weak. Foreign countries eventually resist the interminable export offensive. For both reasons, foreigners began urging Japan in the late 1970s to shift to domestic-led growth. Beginning with the Maekawa Report in 1986, the Japanese government urged itself to make the shift. But for political reasons nothing was ever done. The result has been both a chronic trade war with the rest of the world and now an incipient economic crisis at home.

To the extent China is successful in making this shift, its economic growth will be healthier and its trade problems with the U.S. will gradually be ameliorated. So far, the results have been quite successful. China's housing, car, retail and infrastructure industries have experienced buoyant growth even in a time of global economic slowdown. Last year, China's net export growth was negative, but its economy grew about 7 percent. It has achieved growth without beggar-thy-neighbor currency devaluation. This is the benefit of having had the political courage to take the steps that more prosperous neighbors have been unwilling to take.

Foreign banks should be able to help China accelerate this shift to domestic-led growth, and to do so very profitably. As noted, the dynamos in the shift are housing, cars, consumer spending, and infrastructure. All these are areas where Western banks have superior expertise. The first three also happen to be areas where the Chinese customers have an excellent record of repaying their loans. To the extent the foreign banks participate vigorously in these areas, they will contribute not only to their own profits but also to the continuation of rapid economic growth, to rapid job creation, to the development of sectors where the Chinese banks can become profitable, and to gradual resolution of trade imbalances.

Direct Financial Industry Benefits

China's accession to WTO will lead to a vast opening of the Chinese banking system. Within five years, foreign banks, now restricted to a few cities, will be able to bank anywhere in China. Foreign banks, now largely restricted to foreign currency business, will be able to deal in local currency' of course most financial transactions in China are in the Chinese currency. To the extent that legal and transparency problems are resolved, whole new tiers of business could emerge.

I will not attempt here to estimate the size of the potential markets, but a few comments may be helpful. In every sector that has opened up, there have been optimists and pessimists. In the late 1980s Fortune magazine proclaimed the death of foreign investment in China. Today we debate whether China is hogging foreign investment from the whole third world. In November 1999 a distinguished China scholar published an article in Foreign Affairs saying that the China market was a myth; he didn't notice that trade was headed toward $300 billion per year, that companies were passing the billionth sale of Coke or of soap bars, that China was consistently one of the top two global markets for aircraft, or that China was on the way to having more mobile phones than the United States (something that it achieved last summer).

In 1995 the Chinese stock market was among Asia's smaller markets. Today, except for Tokyo, it is Asia's biggest market. Combined with Hong Kong's, in 2001 it surpassed $1 trillion in market capitalization. (Most of the recent growth of Hong Kong's market was due to the listing of mainland companies.) Historically, before Mao's minions crushed it, Shanghai's stock market was always bigger than Tokyo's. Mao's successors aren't crushing it anymore. The opportunities presented to foreign banks by such developments will begin slowly. Today it is virtually impossible to make a profit by participating in Chinese equity markets. However, assuming the risks noted below, the opportunities should accelerate quite sharply as has occurred in other parts of the Chinese economy.

Similarly, Chinese insurance markets are currently small and primitive. But there is a pervasive need for insurance. The Chinese government's need for help in setting up pension and medical insurance systems may lead to greater participation by private companies than is typical in the capitalist world. If this happens, nobody should be surprised. China's housing and medical systems in the big cities are already more capitalist than Hong Kong's.

The opportunities for U.S. banks and insurance companies in all of this are clearly substantial. China will not soon become one of the biggest profit centers for U.S. institutions, but it is the great frontier, the great source of potential growth at the margin.

The Risks

So far, China has undertaken heroic reforms and been heroically successful. But China is still in a very deep hole, and even its vigorous digging poses risks.

China's banks are still in a very deep hole. China's state enterprises are still in a very deep hole. China's physical environment is in a very deep hole, always susceptible to droughts, floods, and clouds of the world's worst pollution. China's system is very personalized; there is for instance a warm personal welcome for foreign investment, but because the system is based on persons rather than institutional structures and rigorous laws it is susceptible to sudden changes. Digging fast enough to keep from being smothered in these holes requires some of the fastest social change the world has ever seen. If the Chinese leadership were to lose its momentum, or its courage, even for a couple years, it is quite possible, even likely, that all these problems would go critical simultaneously. When we fantasize about the China threat, we need to keep in mind that China remains in a very deep hole and that all its frantic digging is just fast enough to prevent disaster.

There are also risks in the opposite direction. Digging too fast can cause a heart attack. China has been laying of tens of millions of people, cutting its government in half, getting the military out of business, opening its economy to competition, going from one airline to thirty. As financial analysts, we applaud their foresight and their heroism, but governments can step on too many toes at the same time and achieve upheaval rather than prosperity. As people concerned about global stability, we have to be cautious in demanding that China move even faster than it has.

So far, Beijing has kept its balance between these extremes. Given the size of the problems and the scale of the country, maintaining balance has been a remarkable feat.

It is in our national interest for China to keep its balance. It is in our national interest, not just our financial interest, for the emergence of an open, cosmopolitan China to lead to success. We may fear a China that is too successful, but that is not a present danger. Rather, it is a scenario that presumes decades of future balance and future success, neither of which is assured. We have experienced in the twentieth century a China that was divided and weak, a China that was a vacuum drawing in competing predatory powers. Had China and Korea found their balance at the beginning of the century, we would have had European War I and European War II rather than World War I and World War II. Today, as Japan sinks deeper into financial trouble, the last thing we need is a China in trouble too.

China's switch from a policy of revolutionary upheaval to a policy of joining the system has benefited the whole world and in particular has contributed to the stabilization of Asia that was the core postwar goal of the United States in Asia. If that policy of joining the system were to lead to failure, it would drastically set back throughout the world the kinds of open, market-oriented progress we have promoted throughout the postwar era. When Argentina gets into trouble, it raises questions throughout the third world. If China gets into trouble after all it has done, many will see ominous answers rather than just questions.

What We Can Do

In the invitation to testify at this hearing, I was asked to comment on what we could do as Americans to help ensure smooth implementation of WTO.

The first thing and most important thing we can do is to press for proper implementation by China. That is important to us. It is also important to China. The Chinese leaders are counting on us to keep the pressure on.

We can also set a good example by rigorously implementing our part of the bargain, even when some domestic interests squawk. We are demanding that the Chinese make changes at a pace that we would never even consider. We must at least keep our slower-paced promises or there will be a popular outcry in China against the sacrifices they are being required to make.

When there are positive results, we should acknowledge them. The Chinese people remain poor, but they are a lot less poor than they used to be. The Chinese people are unfree, but they are a lot freer than they used to be. Imports from China have forced adjustments in this country, but they have also kept our inflation down and thus played a vital role in perpetuating the longest economic boom in American history. We need to talk about both aspects. We need to talk about the depth of the hole but also need to talk about the speed of the digging.

Given the vital need of both sides for legal progress, we could contribute a great deal by setting up a program to train Chinese lawyers. Since we seem to have a surplus in this country, maybe we could teach some of them Chinese and improve the trade balance by exporting them.

A balanced tone and a sense of humor would probably contribute more than anything else to the successful implementation of WTO and to the broader relationship with China. To a degree that Americans seldom recognize, the Chinese leaders welcome many of our reformist pressures. Nowhere is this more true than with WTO, and within WTO nowhere is to more true than with the rule of law. We have a strong national interest in keeping it that way, but sometimes the stridency of our rhetoric weakens the welcome.

In our relations with both China and Japan, there has been a tendency over the years to humorless exaggeration. We have important issues with them, but we also need to celebrate their successes. We can complain about China's courts and appreciate their efforts to improve their legal system. We can condemn their human rights abuses and applaud the recent improvements in their freedoms. When they get richer, we do too; when they stumble, we do too. Neither Japan in the recent past nor China today has run much risk of taking over the world or of displacing our role. Stridency does not become us, but too often we succumb to it. We are players in a game where we are currently the world champions in every dimension, economically, politically, and geopolitically. We have overwhelmingly important shared interests and we can afford to emphasize them. We can afford to compete and complain with grace and magnanimity.

Chairman D'AMATO. Thank you very much, Dr. Overholt. Your statement will be in the record; it was very interesting.

We'll move on to Mr. Hale now.

STATEMENT OF DAVID HALE, GLOBAL CHIEF ECONOMIST, ZURICH FINANCIAL SERVICES

Mr. HALE. Thank you very much for the opportunity to speak to the Commission.

I think Bill has given you an excellent overview of both the geopolitical and macroeconomic realities of China's current position. I would like to focus more on the opportunities in the financial service industry itself.

The current opening of China's financial service industry as a consequence of the WTO agreement is unprecedented since 1948. There were many foreign players in China's financial service industry in the early decades of the 20th century, including both banks and insurance companies, but all of these operations were shut down in the aftermath of the 1948 revolution. So we really are seeing here today a rebirth of a role for foreign financial institutions in China on a large scale.

I think that if we look out 20 or 30 years, the foreign presence will also be ultimately far larger than it was in the early years of the 20th century because of the sheer scope of the opportunities which will exist in this market as incomes rise, as the economy develops, as China becomes more integrated into the global marketplace.

I think it is important to recognize that China's motives in pursuing market opening and WTO membership are not just the principal liberalization itself. The factors driving this liberalization process are also very much strategic. China views market opening, it views trade liberalization as a way to encourage economic restructuring at home and faster growth of productivity, and therefore, in the years to come, it will be very, very sensitive to how its firms fare in the competition with global players and very, very sensitive to how financial liberalization affects its own domestic financial stability.

As a result of the East Asian financial crisis which occurred 3 and 4 years ago, I think that China will want to move gradually and incrementally in opening up its financial marketplace. It will not want to see within the next 5 or 10 years the kinds of surges in capital flows that we saw in countries like Indonesia, Thailand, and Korea in the first half of the 1990s, which in turn set the stage for the great East Asian financial crisis of 1997–1998, when those capital flows suddenly stopped, when they in some cases changed direction and in general encouraged a process of over-leveraging for a lot of domestic companies, especially in the real estate sector.

I think China is very, very sensitive to the implications of that crisis of 3 and 4 years ago.

We should also note that China's own financial institutions also have many serious problems. The stock of nonperforming loans in the Chinese banking system is 30 or 40 percent; this will be a major burden on the economy. As Bill has indicated, they have begun a restructuring process. They are selling these bad loans. They are trying to privatize the assets that go with them. But we are still in the very early stages of this adjustment process.

China's domestic insurance industry is also only 15 years old. It is relatively new. It was shut down after 1948. There is a growing number of local competitors now, not just international ones, and I think if we take a 5- or 10-year view, some of these local companies could become quite formidable in their own right. But it is important to understand that these are all new companies.

In the securities and fund management industry as well, we have lots of players that were created only in the last 10 years. In the case of the brokering industry, there are some quite prominent firms now, with revenues of over $100 million per annum. In the case of the fund management industry, the players are much smaller and far more modest. Indeed, their total assets under management today are only $6 billion. To put that in perspective, the U.S. mutual fund industry is managing $7 trillion. This is still industry in its infancy.

As the financial liberalization process evolves and unfolds, there is no doubt that two major areas of foreign penetration that will occur first will be banking and insurance. In the case of the banking sector, foreign firms already have one clear niche. They represent today 20 percent of foreign currency lending in China. Under the current rules, they cannot make local currency loans, but over the next few years, those rules will change and allow them to make loans in local currency as well as in foreign currency.

The process of reopening will take place over 5 years, and at the end of it, I think we will see foreign financial institutions trying to make loans to Chinese households as well as to businesses. And the household market could be interesting, because one of the most rapidly growing markets in China today is the mortgage sector; loans in that sector have grown from 19 billion RMB 4 years ago to over 400 billion RMB today. The credit card industry is also still totally in its infancy. So there is no doubt that foreign firms will find many opportunities on a 3- to 5-year view, and I can see them being important players both in corporate and household lending.

In the insurance sector, we will also have an expansion but primarily within the framework of joint ventures or minority shareholdings in existing Chinese companies in the life insurance sector. In the casualty insurance sector, foreign firms can operate on their own.

I think the insurance sector is attractive to foreign firms because it is part of a larger process of financial restructuring tied to the aging of China's population. China today has fewer than 100 million people over the age of 60. In 30 years' time, it will have 300 million people over the age of 60, and in 50 years' time, it might have 400 million or more people over the age of 60. Therefore, because it is following in the footsteps of the aging process that we have seen in recent years in North America, Western Europe, and Japan, there will also be a significant accumulation of assets in the long term for retirement. And there is no doubt this will be considered by both domestic and foreign firms to be a very, very attractive area for penetration and for market development.

We have had a lot of experimentation in the last 3 years in the life insurance sector. Initially, all the products were simply linked to the yield on bank deposits. Now firms are allowed to offer products which are linked to the new bond market as well as to the equity market. So this again will encourage more competition and more innovation as we go forward. And because interest rates in China are so low, the fact is many potential policyholders would like to have exposure to the equity market and to instruments which might offer a higher return over time.

I would also add that economists in Beijing have told me that China today has 80 million retail shareholders already, although the stock market is just barely 10 years old. I think this is a very, very impressive number. I can think of few developing countries in the world where the ownership of equities is so widespread. If we consider Mexico, for example, a country of 100 million people, fewer than one million own a share of stock. If we go to other countries in East Asia, we will also find that the number of equity shareholders is quite modest except for those, as in Singapore and Malaysia, who have access to the equity market through pension fund programs.

Needless to say, as a consequence of the growth in this retirement savings market, there will also be opportunities for foreign firms in the fund management and in the securities market itself.

But here again, because the Chinese Government is so concerned about foreign competition and about the relative lack of sophistication of its domestic institutions, it does not want to give foreign firms a free hand. It is still insisting that for the next few years, at least, they go the joint venture route.

A number of foreign firms are now lining up to pursue joint venture opportunities. We already have half a dozen joint ventures in the fund management business, and we will probably have on a one-year view several more. The major problem for the foreign firms is to find domestic firms that are worthy of being joint venture partners. The fact is there is not a large supply of sophisticated investment professional people in China, and therefore, when you are looking for a partner, it is very difficult to find somebody that you might consider appropriate than if you were doing a joint venture in this country or Western Europe or a more developed country.

But the fact is the Chinese are learning. Their market is 10 years old. It now has a market capitalization of over $500 billion, albeit including still state-owned shares, and I think this is a meaningful development compared to what we have had in many other developing countries in the modern period.

So there is no doubt that the fund management sector and the securities sector will also attract interest.

If I were going to set a goal for U.S. trade negotiators looking out over 5 or 10 years, it would be to try to give the foreign firms the opportunity for more autonomy and more independence to aim for a goal in the year 2010 of allowing foreign firms to operate in these various sectors on their own, not just in the joint venture framework.

The fact is these are highly competitive businesses on a global basis, and joint ventures are not always the optimal way to do it. I think they are optimal in the short term, because they help to reassure the Chinese that they are not going to be overrun. They will help create a more competent group of professionals in Shanghai, Beijing, and other Chinese financial centers. But if we go out 10 years, I do think we should strive to give foreign firms the opportunity to operate autonomously.

There are no real clear models for China's current path. If we look at other post-Communist countries in Eastern Europe, they have had different models for liberalization. Hungary opened up its financial system totally to foreign investment 7 or 8 years ago. Today the Hungarian banking system is 75 percent foreign-owned. Poland also opened up quite aggressively 3 and 4 years ago; its banking system is now two-thirds foreign-owned. Estonia has also been quite open, especially to Scandinavia; its banking system is now 90 percent foreign-owned.

So these are very interesting alternative examples of how some post-Communist countries have pursued financial liberalization and market opening.

I do not believe under any circumstances that China would permit the foreign share of its banking marketplace in the next 10 years to exceed, say, 30 percent. I think it would still want the big four state-owned banks as well as some newly-emerging Chinese banks to still have by far the largest share of the market.

If we go out 20 or 30 years, that of course could change, because by then, they would be more comfortable and more accustomed to it. They might also themselves produce financial institutions that would have global ambitions. The Bank of China, for example, is considering listing its Hong Kong affiliate on the Hong Kong stock exchange later this year. Other Chinese banks might follow.

As these firms list on foreign stock markets, become more global in character, they would of course then share the same agenda as foreign financial institutions in wanting to pursue trade liberalization and market opening. But this will not happen overnight; this will be a process that will take several years.

To summarize, we in our industry see many great opportunities in China over the next 5 or 10 years. We think the process of market opening is very encouraging, and we intend to be a part of it. But we cannot be stationary. We have to watch this market overall, see it develop, and in the 5- or 10-year view, try to pursue new opportunities for further liberalization, further market opening, and truly autonomous operations for foreign companies, not just joint ventures, by the year 2010.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF DAVID HALE

Opportunities for Financial Service Companies in China

China's membership of the WTO will set the stage for an international opening of China's economy and financial service industry on a scale without precedent in the country's long history as a nation state.

The opening of China's economy will create tremendous opportunities for foreign companies in many sectors. But it is important to understand that China's goal in pursuing trade liberalization is to transform its domestic economy. China's leaders believe foreign competition is essential to encouraging economic rationalization and faster productivity growth. As a result, they will be very sensitive to the impact of foreign competition on China's domestic firms, employment stability and social conditions in general. If it becomes apparent that the economic shocks resulting from trade liberalization are much greater than expected, China could attempt to impose either explicit or informal regulatory barriers on foreign competition.

The good news for foreign companies is that China has already experienced a massive foreign direct investment boom which has made the economy far more open today than were other Asian economies, such as Korea and Japan, as recently as five years ago. The cumulative level of FDI in China since the late 1980's has been almost $400 billion. As a result, China has a stock of FDI surpassed only by the United States and the United Kingdom. In 1999, the stock of FDI in Britain was $394 billion compared to $225 billion in German, $164 billion in Brazil, $79 billion in Singapore, $65 billion in Indonesia and $48 billion in Malaysia. In Japan and Korea, by contrast, total FDI during 1999 was only $39 billion and $28 billion. Much of this FDI also resulted from the East Asian financial crisis. Before 1995, the stock of FDI in Korea was only $9 billion.

Most of the FDI in China has focused on the manufacturing and commercial sectors. Foreign financial services firms, by contrast, have faced significant barriers to penetrating the Chinese market. Only a few insurance companies have been licensed to sell products in China and they are primarily confined to the Shanghai area. Foreign banks have only a 1% market share in China and are constrained by geographic barriers to expansion. Securities companies and fund management companies are allowed to enter China only through joint ventures.

During the negotiation of the WTO treaty, China was very reluctant to permit easy access to its financial service market because of concern about how rapid liberalization might destabilize the macro-economy. Chinese officials pointed to the recent East Asian financial crisis as an example of how rapid financial liberalization could encourage excessive growth of leverage and speculative capital flows destructive of economic stability.

As a result of the East Asian financial crisis, China will be as sensitive to how the entry of foreign financial service firms might affect its macroeconomic situation as it will be to the increased competition from foreign manufacturing firms. As Mr. Stephen Harner explained in a recent monograph about the Chinese financial service industry, the Chinese view of financial service development will be driven by strategic considerations, not just adherence to liberal economic values. As he noted:

> "When it comes to its financial sector and financial services, China explicitly rejects the concept of 'international division of labor' based on comparative advantage. It does not matter at all to China that other countries have more efficient and stronger financial institutions and companies which, if allowed to do so, could immediately raise the standards and lower the costs of financial services in the Chinese market. Viewing its financial system as the lynchpin of its economy, China's priority is to develop a strong and stable financial system based on strong and stable indigenous financial institutions that are subject to the control of the Chinese government."
>
> "Given this situation, it is critical for foreign financial companies approaching China to form clear views on two questions: What will be the primary determinant of what type of and how much business my firm will be able to conduct in China? And: What is likely to be the most effective strategy for exploiting the available opportunities?"
>
> "In our view, the key determinant of what will be possible for foreign firms will be the rate at which the domestic industry develops and becomes competitive. In other words, foreign companies will be allowed to participate and develop in the Chinese marketplace to the extent and and at the pace at which Chinese authorities determine that the operations will be beneficial—rather than detrimental—and will contribute to the development of China's financial sector."

Chinese policy makers are likely to be most concerned about the stability of their banking sector because it still plays a dominant role in providing financial intermediation services within the Chinese economy. As the tables below indicate, the banks still provide over 82% of corporate funding while four large state owned banks account for 66% of all lending. They are also massive organizations with 25,000 branches and 1.6 million employees.

TABLE 1.—CAPITAL SOURCES OF CHINA ENTERPRISES

	1995		1996		1997		1998	
	Rmb bn	%	Rmb bn	%	Rmb bn	%	Rmb bn	%
Loan	101.4	88.0	111.4	82.7	114.0	77	115.2	82.6
Direct Financing	13.8	12.0	23.2	17.2	34.0	23.0	24.3	17.4
Securities	1.5	1.3	4.3	3.2	12.9	8.7	8.4	6.0
Bonds	2.2	1.9	2.7	2.0	2.5	1.7	1.5	1.1
Commercial Paper	10.1	8.8	16.3	12.1	18.6	12.6	14.4	10.3
Total Financing	115.2	100.0	134.7	100.0	148.1	100.0	139.5	100.0

Source: China Financial Outlook, 1999 DBS Vickers Securities, Economic Focus, Nov. 16, 2001.

TABLE 2.—MARKET SHARE OF FINANCIAL INSTITUTIONS IN CHINA

	Rmb bn Total Asset	% of Market Share	Total Loan	% of Market Share	Total Deposit	% of Market Share
State-owned Commercial Banks	8,259	66	6,231	69	5,948	66
Policy Banks	569	5	552	6	1	0
National Commercial Banks	1,148	9	584	6	835	9
Urban Credit Cooperatives	561	5	401	4	608	7
Rural Credit Cooperatives	1,143	9	881	10	1,216	13
Foreign-funded Banks	283	2	223	2	40	0
Total	12,420	100	9,092	100	9,012	100

The existing banks enjoy several advantages over potential foreign competitors. They have vast retail networks which provide them with low cost liquidity. They know existing corporate customers in both the state owned and private sectors. They will be protected from competition in consumer lending for five more years at a time when mortgage lending is one of the most rapidly growing sectors. Housing loans, for example, are now nearly 400 billion RMB compared to only 19 billion at year-end 1997. But the big four state owned banks also have serious problems. They have a stock of non-performing loans equal to 30–40% of their total assets. They have limited experience in lending money to private companies. The government relies heavily on the banks to fund its capital spending and thus discourages them from playing as active a role in the private sector as might now be appropriate.

At the end of 1999, there were 155 foreign bank branches in China. Of these, 25 had obtained licenses to conduct business in the Chinese currency within severe limits. The banks were allowed to lend only to foreign invested enterprises and to keep RMB liabilities within 50% of the total. At the end of 1999, total foreign loan volume was only $18.3 billion compared to a peak of $27.5 billion in 1997.

As a result of the WTO agreement, there is likely to be a significant expansion of foreign banking activity in China during the next five years. Under the new rules, foreign banks can now make foreign currency loans to both Chinese companies and individuals. Within two years, they will be able to make local currency loans to Chinese companies. Within five years, they will be able to make local currency loans to Chinese individuals as well as expand anywhere in the nation. Enterprises now account for 35% of China's bank deposits while households represent another 52%. Foreign banks will focus on enterprises during the next few years and then widen their focus to retail business after 2005.

The major new concern of foreign banks is the cost of foreign currency deposits raised within China. In December, the foreign banks were being forced to pay a premium of 1.5% over the cost of funding (2.57%) in the local foreign currency inter-bank lending market. This funding cost is of great concern to the foreign banks because they now control 20% of all foreign currency lending in China compared to a total market share of only 2%. It appears that the foreign banks have been funding themselves with money from overseas because of barriers to using the local market. If China imposes regulatory barriers to the foreign banks utilizing the domestic foreign currency inter-bank lending market, it could slow the expansion of foreign banks compared to their perceptions of the opportunities offered by the WTO Treaty.

China has also introduced policies to require foreign banks to add significantly to their capital as they expand in the country. Under the new rules, banks will have to provide capital of 200 million RMB per branch if it does foreign currency lending and 300 million RMB if it does both domestic and foreign currency lending. In five years the capital requirement will rise to 600 million RMB. These capital requirements will depress the profitability of Chinese branches during the early years and thus make foreign banks more cautious about the speed at which they will expand beyond the traditional financial centers. Hong Kong stock analysts, for example believe that the new capital rules will reduce the return on equity of existing China branches of Bank of East Asia from 30% to 15%.

The Insurance Sector

China is also opening up its insurance sector to widespread foreign participation for the first time since before the 1948 revolution.

There were many foreign insurance firms in China during the early decades of the 20th century. The big American firm, AIG, actually began in Shanghai about the time of the First World War.

The foreign firms were nationalized by the communist government after the revolution. The government then shut the whole industry down during the 1950's and 1960's except for cargo insurance. The government began recreating an insurance industry in 1985 by establishing the People's Insurance Company of China.

During the past quarter century, the insurance industry has grown rapidly. Insurance premiums have mushroomed from 300 million RMB in the early 1980's to 159.6 billion RMB in 2000. In 1991, 76.8% of insurance premiums were for non-life products and only 4 billion RMB (23.2%) went for life insurance. In 2000, the situation reversed. The life insurance share of premiums rose to 62.5% while the non-life share shrank to 37%. The change reflected the fact that life premiums grew twenty five fold after 1991 while non-life premiums grew 4.5 times.

In 1999, China's insurance market was slightly larger than Sweden's but still smaller than Taiwan, Switzerland and Canada. In 1999, China's insurance premiums were $17 billion compared to $16 billion for Sweden, $20 billion for Taiwan, $11 billion for Brazil and $8 billion for Mexico. Industry observers expect that the Chinese market will expand to $34 billion by 2005 and $60 billion by 2010. Such growth would make the Chinese market nearly as large as Italy today ($67 billion) but still much smaller than France ($123 billion) or Germany ($139 billion).

Despite the long history of state domination, China's insurance market has become more competitive during recent years. China Life, the traditional state owned company, still controls about 70% of the national market. But a highly aggressive new player, Ping An, has captured about 20.5% of the market while a third player, China Pacific, has about 7.5%. In the big urban markets, Ping An has actually displaced China Life from top place. In Shanghai, Ping An Life Insurance has a market share of 44% compared to 29% for China Life and 10% for China Pacific. In Beijing, Ping An has a market share of 40% compared to 21% for China Life and 18.4% for another new independent company, New China Life.

Foreign firms have so far been confined to the Shanghai market, except for AIG. In 2000, the foreign firms enjoyed a modest market share in Shanghai. AIG had premium income there of 315 million RMB compared to 884 million for Ping An and 296 million for China Life. Other foreign firms included Manulife (68 million RMB), Aetna (67 million RMB), AXA Minimetals (25 million) and Allianz Dazhong (23 million RMB). AIG has the largest market share because it enjoys a ten year head start over other foreign players.

Ping An is still a state owned company, but it plans to list on the stock exchange in the near future. Zurich Insurance has a large shareholding in New China Life and hopes to expand its stake in the future.

In former communist countries, insurance was often sold on the basis of group policies through employers. In China, group policies are important but individual policy sales are growing more rapidly. In Beijing, for example, individual sales are now equal to 65% of all sales compared to only 47% two years ago.

Until 1999, the primary life products offered by all companies were ordinary life, endowment life and pension insurance. Yields were fixed and linked to bank deposit rates. As interest rates fell to low levels during the late 1990's, the low returns discouraged demand for traditional life products. But the government then relaxed the rules and permitted more experimentation with investment linked products. Ping An, for example, introduced a product linked to the securities market which received an enthusiastic consumer response. Since March 2001, companies have been able to offer policies with three possible investment options; government bonds, commercial bank deposits, and securities investment funds. The equity option is one of the three dozen securities investment funds managed by China's ten authorized investment management companies.

The WTO Treaty will open the dollar for further expansion of foreign firms in the Chinese insurance industry.

Under the rules, foreign firms will be allowed to establish branches to sell non-life products.

In the life insurance sector, foreign firms will have two options for development. They can establish a joint venture with a Chinese company and have a shareholding which does not exceed 50%. They can purchase a 25% market share in an authorized domestic Chinese life insurance company.

The exception to these rules is AIG. As a result of its early arrival and close relationship to the Chinese government, it has been allowed to establish a business without a JV partner and to operate in more areas than Shanghai. But as a result of the WTO agreement, it will now be allowed to expand in only four more cities and will have to pursue a JV agreement to operate elsewhere.

Most foreign firms have gone the joint venture route. New York Life recently formed a JV with the leading appliance company, Haier. In 1996, Manulife of Canada formed a JV with the conglomerate, Sinochem. AXA formed a joint venture in 1999 with the metals trader, Minimetal. Allianz has a joint venture with the Dahzong taxi company. The problem with the JV's is that they are still subject to severe geographic limits (primarily Shanghai). They also require minimum capital of 100 million RMB. The geographic constraints will be phased out in 2003 and 2005.

Two foreign firms have decided to become minority shareholders in existing Chinese companies with national distribution. Zurich has a large shareholding in New China Life while Winterhur has purchased a large stake in Taiking Life. As these firms have diverse ownership, it is likely that Zurich and Winterhur will expand their shareholdings in the future.

In the decade ahead, the Chinese insurance market is likely to enjoy both rapid growth and an increasing level of competition. Many foreign firms are attracted to the potential scope for future market development in China. They are especially intrigued by the fact that China will be a potentially huge market for products focused on retirement savings. At present, China has a primitive pay as you go pension system in its state owned companies. There will have to be a further massive expansion of retirement savings as China's population ages. On the basis of current population trends, China's old age dependency ratio will rise from 11% in 1999 to 25% in 2030 and 36% in 2050. In 2030, China will have 300 million people over the age of 60 compared to fewer than 100 million today. Goldman Sachs has produced reports suggesting that China will need $3.2 trillion of pension assets in 2030 to provide retirement income for its people. If China introduces personalized retirement savings products rather than just employer plans (defined contribution rather than defined benefit) the assets could even grow to $6.4 trillion. Personal pension products could be attractive because China is estimated to already have 80 million retail shareholders compared to 55 million members of the Communist Party.

The growth of retirement savings will also have profound implications for the development of China's capital markets. Pension funds need to invest in securities, so their growth will also fuel expansion of stock and bond markets. China re-opened its equity market after a forty year suspension in 1990. The number of listed companies has grown from 14 to nearly 1,100. The market capitalization now exceeds $525 billion or a sum just over 50% of GDP compared to numbers in the 20–60% range for many developing countries. China also has developed markets for Treasury bonds and corporate bonds. In 1999, the T-bond market was worth 401 billion RM. The corporate bond market is much less developed. At the end of 1999, there were only 10 listed bonds with a market value of 50 billion RMB. But bond issuance during 1999 rose to 20 billion RMB, so there is potential for the market to expand more rapidly in response to both institutional and retail investor demand.

Foreign investment service groups are excited about the potential opportunities in China's emerging capital markets. They hope to establish niches in both the stock broking and fund management sectors. At present, China has 101 licensed brokerage firms and ten fund management companies.

As a result of the recent boom in stock trading and company IPO's, five of China's brokerage firms had profits last year which exceeded $100 million. The ten fund management companies are very small. They control about $6.8 billion of assets spread over thirty three closed end funds. As a result, they represent a very small share of the market compared to mutual fund companies in North America or Western Europe. But in recent months they have begun to introduce open end funds and pursue joint ventures with foreign managers in order to improve their level of professional competence. In fact, six of China's fund management companies now have joint ventures with foreign firms. Three British firms have formed joint ventures compared to one Canadian and two German firms. Two American banks have formed joint ventures to offer trustee services while it is likely that other American groups will pursue joint ventures in the fund management industry itself.

Under the WTO rules, foreign firms cannot enter the securities or fund management sectors on their own. They have to pursue joint venture agreements and accept a shareholding of less than 33% during their initial years. As Chinese firms have far less experience in both the securities and fund management sectors than foreign firms, it is clear that China wants to open these sectors very gradually in order to develop a higher standard of professional competence among its own people.

Conclusion

The development of the financial service industry in China will offer many exciting opportunities for banks, insurance companies, securities firms and other players in the industry. China has the potential to emerge during the next fifty years as one of the largest markets in the world for a wide range of products. But China will also want to regulate the speed of market liberalization in order to nurture its own companies and lessen the risk of macroeconomic instability resulting from speculative surges of bank lending or other capital inflows. The East Asia financial crisis of 1997–1998 was a stark reminder that global banking institutions often pursue reckless lending policies when they enter new markets for the first time.

The implementation of China's WTO agreement should be more transparent in the financial service industry than in the manufacturing and commercial sectors. It is easier for countries to impose informal barriers to trade in goods than trade in financial services. As Japan has often demonstrated, it is possible to inhibit goods trade through health and safety regulations as well as restricted access to the distribution system. It is possible to block trade in financial services only through explicit regulatory actions which have to be publicly announced for all to see. The Chinese government could attempt to guide the business of state owned companies to state controlled financial institutions, but as the state owned companies represent a rapidly shrinking share of total economic output and suffer from significant credit quality problems it is doubtful that such policies will significantly impede foreign financial institutions. On the contrary, most foreign banks want to focus upon China's new private sector, especially the entrepreneurs leading the way in wealth creation and promotion of economic growth.

As China becomes more comfortable with a significant foreign presence in its financial service industry, negotiators from the U.S. and Europe should attempt to remove the barriers to majority control of fund management and securities firms.

Joint ventures are a useful way for foreign and Chinese companies to become familiar with each other during the first stages of China's integration into the global financial system, but they are unlikely to be an optimal strategy for such highly competitive businesses indefinitely. It is also quite possible that the sheer size of China's economy could set the stage for a major Chinese financial services group to emerge which might want to play a role elsewhere in Asia or in the world as a whole. Such a firm could then emerge as a lobbyist to remove China's trade barriers in order to enhance its market access in North America or Europe. The Bank of China is already making plans to launch its Hong Kong subsidiary on the local stock market. In ten years, the Bank of China might want to play a role underwriting securities or offering other corporate finance services far from China. In such a scenario, it will not want to be constrained by the side effects of restrictive trade policies at home.

The financial service industry was one of the first to pursue global opportunities during the 19th century through the export of capital from London to developing countries elsewhere in the world. But despite the fact that capital is mobile, there has been little cross border integration of financial service firms. Most companies are still rooted in the regulatory and tax framework of a particular nation state even if they have offices in many countries. London continues to be the most global financial center because of its history as an intermediary for offshore money and the willingness of Britain to let foreign firms completely dominate many sectors of its financial service industry. But in the next generation, there are likely to be more cross border mergers of national firms because of the impact of technology on the cost of international activities and the pressure on institutions in the old industrial countries to diversify into new high growth regions. As this transition occurs, China will initially play host to many more foreign firms and then gradually nurture financial institutions which will themselves emerge as global players. When Shanghai becomes a regional and then international financial center, the trade agenda of China's financial institutions will increasingly converge with the American, European and Japanese companies now seeking access to China's market.

Chairman D'AMATO. Thank you very much, Mr. Hale, and your statement will be in full in the record.

We'll move on to Mr. Shoyer now. Thank you.

STATEMENT OF ANDREW W. SHOYER, PARTNER, POWELL, GOLDSTEIN, FRAZER & MURPHY

Mr. SHOYER. Thank you, Chairman.

As I am batting cleanup, I will focus my remarks on the things I know best from working with financial service firms, and that is within the legal context: how will financial service firms in the China market take advantage of WTO commitments?

In my written testimony, I have sought to identify the benefits of China's WTO accession, to look at the challenges ahead, and also to suggest how we can ensure compliance short of pursuing an endless, contentious stream of disputes through formal WTO dispute settlement mechanisms.

I think the benefits are clear. China has been fully integrated as a WTO member and its regulatory system will be fully disciplined by WTO rules. I see four important elements of the application of these WTO rules to China.

First, the requirement of transparency under the General Agreement on Trade in Services is going to form the basis of all China's regulatory reforms. That requirement not only requires Chinese regulators to operate in a transparent manner, but also to provide procedural due process. That is going to be critical.

Similarly, three other elements of the GATS framework will greatly benefit foreign financial services firms. These firms can pursue market opportunities with the certainty that they will be protected against discriminatory treatment both by China's commitment to accord MFN, or most favored nation treatment, and its commitment to accord national treatment. Also foreign financial services firms will benefit from a broad range of market access commitments on trade in service. For example, the linkage to the telecom annex will help ensure that financial services firms will have full access to the basic telecommunications network in China.

The challenges, though, are enormous. In addition to the ones that previous speakers have mentioned, I want to note two recent situations.

First, interim regulations on the purchase of shares by asset management firms were published by Chinese authorities on December 20, and comments were sought by December 31. That was a problematic deadline for U.S. asset management companies eager to ensure that the regulatory process would take into account their views. I believe that the U.S. industry has submitted comments as quickly as possible. I offer this example as a clear harbinger of the problems that lie ahead. This kind of "efficiency" is going to be problematic if China imposes such short deadlines for comment. Clearly, foreign firms are going to have a great deal of difficulty responding that quickly. China appears to have given us what we have asked for—there is transparency in its regulatory process, and we have been given the opportunity to comment. But the question is whether that is really a meaningful opportunity to comment.

Second, I also note in the news this week that China's new insurance regulation did not include all of what our industry felt was required by WTO. I know that industry representatives have talked to USTR and that there is going to be a fairly significant delegation going to China next week. Here again, we see that the regulatory process is moving forward and moving quickly. The concern for U.S. industry is that not all the elements that industry thought were required of China have been included in this first round of regulatory reforms.

Finally, let me suggest three specific ways to help to ensure China's compliance with its WTO commitments, short of formal WTO dispute settlement.

The first is active, serious, consistent capacity-building efforts. And when I talk about capacity-building, I mean not only those at the government-to-government level, but also a significant role for the private sector. As I mentioned in my written testimony, the most effective exercises that I have seen—and I have been involved in several in China in the last 6 months—have been those that combine the talents of government experts, experts from international organizations, and experts from industry. When government regulators from China hear only the explanations of government regulators, their eyes sometimes glaze over rather quickly. Because what they are hearing is simply how another government has done things, and it is not always easily translated into China's experience.

But what is particularly effective is when a government expert providing technical assistance can point to a private sector representative and say, "Tell us about your experience in a country. What are the best practices as you perceive them?" Industry experts can provide very vivid examples. Indeed, I can think of very effective uses of industry experts in recent training sessions in Beijing and in Shanghai.

Secondly, it will be essential for the private sector to integrate WTO rules into their own dialogue with Chinese government regulators. It will be important to educate our private sector about what rights they enjoy as a result of China's WTO accession, so that when our firms do speak directly to the relevant Chinese regulators, they can make effective use of the rules. And that is going to take education from our side as well as from the Chinese side.

Finally, we need to use the WTO councils and committees creatively to seek solutions short of formal dispute settlement. There is a committee in the WTO for almost every WTO agreement. In addition to the special annual review of China's compliance, these councils and committees will provide opportunities to discuss regulatory problems in China.

They are also the focal point for notification to the WTO. China's WTO notification commitments will serve to reinforce its transparency requirements. In addition to direct transparency—that is, transparency of the regulatory system directly in China—the Chinese Government regulators will have to notify the WTO, and those documents will be immediately available on the WTO website in English, French and Spanish. So the private sector will benefit twice from transparency—both directly, because of the transparency requirement that applies domestically to China's regulatory system, and secondly, in the WTO, because of the requirement that China's notifications be circulated and available to all, and not only to WTO Member governments.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF ANDREW W. SHOYER

Thank you, Chairman D'Amato, Chairman Mulloy and Members of the Commission, for inviting me to testify today. I am Andy Shoyer, a partner in the Washington, DC office of Powell, Goldstein, Frazer & Murphy. Prior to joining the firm, I served for seven years with the Office of the U.S. Trade Representative, most recently as Legal Advisor in the U.S. Mission to the World Trade Organization in Geneva. Then as now, the primary focus of my work is to help U.S. companies and industry associations to use WTO disciplines to address market access barriers and unfair conditions of competition abroad.

The accession of China to the WTO late last year has presented our financial services industry with enormous opportunities. We advise a number of companies active in financial services markets in China. In support of that work, I traveled to China twice last year in capacity-building efforts with Chinese government officials on WTO implementation. It is from that perspective that I offer testimony today about the benefits that should accrue to the U.S. industry from China's financial services commitments, the challenges that lie ahead, and the means (short of formal WTO dispute settlement) through which we can maximize the benefits of these commitments. I will begin by outlining the benefits that U.S. industry should derive from China's WTO commitments.

Part I: Benefits

To set the stage, let me briefly describe the competitive conditions faced by U.S. financial service suppliers in China in the absence of WTO disciplines.

According to the Office of the U.S. Trade Representative, China's services sector has been one of the most heavily regulated and protected parts of the national economy. Foreign banks and securities firms have faced a restrictive, opaque regulatory environment. They could not engage in local currency business except in Shanghai and Shenzhen. There were numerous discriminatory regulatory burdens placed on foreign banks that appeared to have no rational relationship to "prudential" criteria.

Independent auto and other vehicle financing (i.e., financing by non-banks) was prohibited, as was financial leasing.

Market access for insurance service suppliers was similarly restrictive. Prior to WTO accession, 16 foreign insurers were licensed to operate in China, mainly in Shanghai or Guangzhou.

And securities firms have been able to trade only in "B" shares (small quantities of stock designated for foreign investors) but only on a shared commission basis, and to underwrite only international securities offerings. Market access for foreign asset management firms was very limited.

China's WTO commitments provide new and significant opportunities for U.S. financial services providers:

—Geographical limitations are eliminated within 5 years of accession and rigorous limitations on product offerings are lifted.

—In banking, local currency services are permitted and the requirement of approval, on a case-by-case discretionary basis, for each new representative office or branch has been eliminated.

—Auto financing by non-banks is now permitted, and financial leasing will be open to foreign service suppliers when domestic institutions are permitted to do so.

—In securities, the prohibition on investment and the underwriting of securities is ended.

—And, in insurance, providers are able to offer life, non-life and reinsurance products as well as group and pension policies. Restrictive licensing procedures are eliminated. Moreover, providers are released from the requirement of operating with a government-selected partner.

Certainly, U.S. financial service firms did not get everything they hoped for in China's WTO accession package. But the benefits of these commitments to U.S. financial service suppliers should be very significant. For example, according to USTR, even the most conservative estimates predict that total insurance premiums in China will reach $15–30 billion in the next few years. U.S. industry estimated that, if China were to lift its market access barriers completely—which it will over time—U.S. insurance providers should capture more than $2 billion of that market.

But the range of American beneficiaries of China's financial service commitments is hardly limited to U.S. financial service suppliers. Our financial service suppliers are among the most efficient, dynamic and innovative in the world. Their active participation in China will enhance the quality of financial services throughout the country. This improved financial infrastructure will, in turn, make it easier for other U.S. companies, who will depend on high-quality banking and insurance services, to thrive in that market.

Part II: Challenges

These benefits can only be achieved, however, if China implements its commitments. Based on my discussions with U.S. firms and Chinese officials, there are real challenges ahead. As new regulations are promulgated, Chinese courts will have to take on the burden of interpreting them. Yet the rule of law in China is still emerging, and there has been little experience for Chinese courts to draw upon in addressing legal issues affecting capital markets. Moreover, Chinese capital markets lack an effective ratings system, disclosure requirements are poor, transparency is lacking, bankruptcy procedures are underdeveloped, and the government domestic bond market is still developing. The domestic banking system itself is hampered by the lack of a credit culture, numerous non-performing loans, poor balance sheets, and little diversification.

Foreign competition secured by WTO commitments will help to address many of these problems. For example, the implementation of WTO commitments on transparency and procedural due process will help enormously to underpin the reforms needed in China's judicial system. But I see two additional risks associated with WTO implementation.

First, it will be more difficult to educate and discipline provincial and municipal regulators than it will be at the national level. There are many more local officials and (notwithstanding Western stereotypes of China's one-party rule) China is far from a monolith in terms of governance. These officials will resist change and resist the notion that international rules discipline their freedom of action. Yet the actions (or inaction) of government regulators at the sub-national level play a significant role in the life of financial service suppliers, and will therefore play a significant role in China's overall compliance record.

Second, but equally important, as foreign service suppliers increase the scope of activity in China, less competitive domestic service suppliers will surely press government officials to maintain or erect barriers to protect their positions in the market. China has had little experience with open competition within its borders. We have great difficulty resisting the siren song of protectionism here at home. How will Chinese government officials fare?

Part III: Ensuring Compliance

One of the great advantages of having our trade relationship with China governed by WTO commitments is that they are enforceable through dispute settlement. We advise many clients on WTO compliance matters and formal WTO dispute settlement has proven to be a remarkably effective tool in many cases.

But dispute settlement cannot serve as the only means through which China's trading partners seek compliance with China's WTO obligations. Nor can we afford to stand aside and hope and pray that China will do the right thing. Instead, enforcement efforts must be combined with, and preceded by, serious and consistent efforts to provide technical assistance. Indeed, all of us with a stake in the success of China's WTO implementation—private companies, industry associations, government officials and international bodies—must assist China to build its capacity to meet its WTO commitments. As I mentioned, I have been involved in several technical assistance programs, both here and in China, designed to educate Chinese officials about WTO substantive and procedural obligations, give them specific examples of how other governments meet those obligations and to suggest how these "best practices" might be translated into the Chinese system. In my experience, the most effective programs have combined government regulators and private sector expertise, so that private companies can explain which practices have worked well in the past, and which practices have not.

Part IV: Conclusion

In conclusion, there is much work ahead, but I am cautiously optimistic that U.S. industry can and will secure the benefits of China's WTO commitments in the financial service sector.

I appreciate the opportunity to participate in the important work of the Commission, and would be pleased to answer any questions.

PANEL III DISCUSSION AND QUESTIONS AND ANSWERS

Chairman D'AMATO. Thank you very much, Mr. Shoyer.

I compliment all of you on the excellent testimony.

I must say that Dr. Overholt didn't do himself total justice in terms of the written remarks that he provided us, and I want to quote one or two little items that I think highlight the question that I want to ask him.

He said: "The financial dilemma is a microcosm of the larger Chinese system. The good news is that China works much harder than anyone else at digging itself out of a hole. The bad news is that the hole is frighteningly deep. Optimists look at how hard the Chinese work at filling the hole. Pessimists look at how deep the hole is. Both have plenty of exciting numbers."

I think it is very interesting the dilemma that we see here. "The risk to China," you say, "is that the foreign banks come in and take the best customers, leaving the Chinese banks decapitated."

You also suggest that foreign banks can act as teachers for the Chinese banks. If I were a Chinese bank, I would wonder who was coming through the door—the teacher or the eater.

How do you do that without having intermediary institutions help do the job of teaching the Chinese banks how to operate and giving them the assurance that they are not going to be just overwhelmed. Do you think there needs to be some kind of a government program that helps to make the adjustments in the financial system that can lead U.S. financial institutions to help Chinese banks become more adept at operating and in that way maybe accelerate the opening of the Chinese banking sector to American financial institutions?

Mr. OVERHOLT. I suspect that they are about as effective by themselves as they would be with foreign government help. They are doing a number of interesting things. Just to start with how deep the hole is, in most of China, the system of sending and cashing checks doesn't work. If you send a check to somebody in rural China, the bank will say "We don't have the money. Come back in 3 or 4 or 5 or 6 weeks." Most people even in Beijing pay all of their utility bills in cash.

What they have done is, first of all, to create a kind of one country/two banking systems. The banks have created some elements that are becoming highly effective. If you look at Bank of China in Hong Kong, there are some very impressive things going on there. They are going into internet banking in a way that most of the world isn't yet. So they are creating an elite that can compete.

The second is what David Hale mentioned—they are trying to force a lot of joint ventures, and that way, they find themselves working together with the foreigners.

I suspect a lot more is going to be necessary. I refer in the paper to the Korean model, where Korean banks 5 years ago were essentially like Chinese banks today, and they just got shattered. But the seriousness of the crisis that they dealt with brought foreigners in in a big way, busting a lot of their own banks—38 percent of all Korean bank employees got laid off. And now, amazingly, after only 4 years, it is starting to work reasonably well.

So I can't offer you any assurance as to how well it is going to work, but they do have some mechanisms, and they are willing to do very tough things to themselves.

Chairman D'AMATO. Yes, they are, apparently.

Commissioner Wessel?

Commissioner WESSEL. Thank you, Mr. Chairman.

I thank all of you, and Mr. Hale, it is good to see you again, as always.

Right after the Asian financial crisis in 1997, there were dramatic hopes that China would not engage in currency manipulation but would seek to help stabilize the region. What is the current status of currency regulations related to freely floating, not freely floating bands in which the RMB can travel, can trade, etcetera? How does their system work right now?

Mr. HALE. They have a fixed exchange rate. It is 8.3 to the American dollar. There is some modest fluctuation around that, but they have had a pegged exchange rate now for several years. There was great discussion 3 or 4 years ago about devaluating. In recent weeks, China has been complaining publicly about Japan's policy of devaluation—the yen has fallen from 120 in November to 133, 134 recently—but there is no sign they will devalue in retaliation. But they and the Koreans and the Malaysians have all complained quite vociferously in the last 2 weeks. They don't want a big Japanese competitive devaluation.

Commissioner WESSEL. And has there been any discussion that if they were to face major economic problems, they would engage in changing the value?

Mr. HALE. Well, the problem is that if they actually floated the currency, it might appreciate slightly. There is so much foreign direct investment going into China, plus the potential portfolio capital when they liberalized the stock market, that it could be a firmer currency, not a weaker currency.

So there is a two-way debate about this, but there is no doubt in a 5-year view, if the WTO accession process leads to a massive increase in imports that wipes out the trade surplus, and foreign investment falters for some reason—maybe a weak economy or a change in sentiment—that Chinese currency would then be a clear candidate for devaluation. But I still think that that is a few years away, and it depends very much on China's performance. If their companies can compete and be effective, as they can already in many sectors—we can see this clearly in television, appliances, and a wide range of products where they now export aggressively to Asia, don't just import—they will be fine. But if they are overwhelmed, and they are under pressure, then they will do what all countries do—consider devaluation as one way to meet the competitive challenge.

Commissioner WESSEL. And if some of the proponents of accession are correct, number one, that our exports will go up, and number two, that we will not see the migration of productive capacity—just as you said, 5 years hence, we may see them devalue—are there any responses that we can take at that time under the WTO—other than manipulating our own currency?

Mr. HALE. Well, currency devaluation is a policy option for all countries; it is not covered formally.

Commissioner WESSEL. But it is not actionable under the WTO, is it?

Mr. HALE. As I understand it, it is not, no. But let me just say that I think what we are talking about over 3 to 5 years would be a relatively modest currency adjustment, maybe 10 or 15 percent. And again, I don't want to forecast that right now, because I have no clear scenario for that to happen. China's economy is doing fine right now. All we can do is speculate about how this might change over 2 or 3 years.

Let me also add that China's exports are about to go through some quite profound transformations for reasons independent of WTO. In the year 2005, we are going to end the current quotas on textile trade. Those are a major barrier to Chinese exports today. Once those quotas go, China's exports would increase dramatically, for reasons quite separate from WTO.

Secondly, the Taiwan corporate sector is now moving a significant share of its productive capacity for high-technology goods—semiconductors, computers, et cetera—to the mainland. So what used to be a tiny industry in China will, over 3 to 5 years, become very large and give them a whole new growth locomotive. The only problem with that is that, as we have seen recently in Singapore, Malaysia, and Thailand, that then makes you more vulnerable to global business cycles. Singapore is now in a very powerful recession because of the American electronics downturn. Our industrial production year-on-year is down 6 percent; they are down 17 or 18 percent, because they depend so much on these sectors. Five or 10 years ago, Taiwan had textiles and shoes on the mainland; now it is bringing in high-tech, and this will be a very, very powerful engine for growth.

Commissioner WESSEL. Let me turn quickly to the investment, the equity sector, and disclosure transparency—you talked about the importance of that—is one of the basic tenets of our securities law. How much transparency is there for these 80 million stockholders, equity-holders, in China? Do they get full information? Do they know ownership? Are they being protected, I guess, against the Enrons of this world—not that we were, but——

Mr. HALE. Well, we were; I mean, Enron went bankrupt. Our system did work.

Commissioner WESSEL. That's a good point.

Mr. HALE. The only problem is that I'm told in the White House this morning that when we have the trial, it will be held by military tribunal, just to keep it under control.

[Laughter.]

The answer is that China has 1,080 publicly listed companies. The quality of accounting is very diverse, and we have had some clear examples of fraud—major fraud. But the good news is that it was revealed over the last year in the Chinese financial media by investigative journalists who were given the privilege, the freedom, to write these stories and to publicize these things.

Indeed, China Online, whose president is speaking this afternoon, is now carrying this information—the English language version—on its website starting 2 weeks ago. So this is going global now, and not just in China itself.

So this kind of investigative journalism is critical to cleaning things up. The problem is that China does not have a long tradition of good corporate governance, of good accounting, and all the things that go with that. But the trends are in the right direction, and if we go out 5 or 10 years, I think it will get steadily better. And for the companies that want to go on foreign stock exchanges—that is, Hong Kong, New York, Singapore, Melbourne or Sydney—they have to have international accounting standards and international accounting firms do their work. A couple of them have had problems. We had a company called Netease that was on the stock exchange delisted for 6 months because it didn't file an annual report. But the fact is our clause came into play, and the company was delisted. Then, it finally submitted all the accounts to get back on the exchange.

So our standards of governance did play a role in making the company conform to good standards for corporate governance.

Commissioner WESSEL. Thank you.

Chairman D'AMATO. Dr. Overholt, did you want to add something?

Mr. OVERHOLT. Yes, just one comment. As in the other areas, they are in a very deep hole, and they are digging hard.

When they started with international accounting standards in 1992, they had only 50 seriously trained accountants in China. They recently introduced quarterly reporting, which Hong Kong tycoons have successfully resisted as a requirement of the Hong Kong Stock Exchange.

This is an indication of how fast they are trying to move, but it takes time when you don't have any accountants.

Mr. HALE. Another important factor to understand is that the Chinese Stock Market is today 95 percent state-controlled companies that have been privatized by the government 30, 40 percent. They are not truly private in our sense of the word. But at some point in the next 12 or 18 months, the government is committed nominally to creating a new stock exchange for the private sector—and believe me, there are thousands of companies that would like to go public to raise capital. When you have the private sector in the marketplace, not just the government companies, I think that will also be a very, very important development. And with luck, the private companies will play a path-breaking role in respecting shareholder rights and principles of corporate governance as we understand them.

Again, this whole process is still highly evolutionary.

Chairman D'AMATO. Commissioner Robinson?

Commissioner ROBINSON. Thank you, Mr. Chairman.

I would like to follow up on Commissioner Wessel's line of questioning a little bit. I think most of us would agree that the Enron collapse and Arthur Andersen's travails, military tribunals notwithstanding, have underscored at least the need for strengthened transparency and accountability in our own markets. This Commission has received testimony in the past that has indicated that China continues to be plagued by widespread corruption and nepotism, lack of disclosure would be putting it generously, and questionable accounting practices. You have alluded to some of them.

Some of the afflictions, however, are also on display presently in the case of Chinese firms that are already listed on the New York Stock Exchange or planned IPOs in the near future. I am thinking here of at least a couple of recent examples of alleged nepotism, at least according to The Washington Post, on the part of Huaneng Power, which you may have seen; the suspicious dismissals of key executives working for or associated with the Bank of China which, as you mentioned, Mr. Hale, plans to go IPO in Hong Kong and I thought New York as well, later this year.

Basically, I am curious as to whether you are concerned at all about the ability of, for example, the Chinese firms mentioned to withstand what I think will be the brighter lights of post-Enron scrutiny, or in those two cases if you are familiar with them, whether you think they will get a clean bill of health, but more broadly as well, if you wouldn't mind expanding that comment, to Chinese firms that are bound for the New York Stock Exchange and the portfolios of American investors, as you know, there is a less tolerant event here, and I am just curious if you think that, again, now, if we agree that the lights are on for Cisco Systems much less Bank of China, how are they going to fare under those bright lights?

Mr. HALE. That's an excellent question, and again, there is no simple, straightforward answer, because it will vary by company, but let me just talk for a minute about this very important announcement on Monday that the head of the People's Construction Bank, the former head of the Bank of China, was compelled to resign and is now under investigation by the government for corruption.

As I understand it from my sources, he was removed from this position because he was a party to an attempt by a Chinese telecom company to come to the U.S. to go public to raise money through fraudulent accounting; he was a party to this and was compensated for it.

So if the Chinese authorities remove somebody as prominent, as influential, and as visible as this individual has been in recent years—at the Davos World Economic Forum, IMF meetings, all the great China economic conferences over the last half dozen years—that is a very striking commentary on China's attempt to police itself.

Commissioner ROBINSON. China International Capital Corporation chairman as well, wasn't he?

Mr. HALE. Yes—again, because of the joint venture with People's Construction Bank.

The point is—and we are still getting the details on this—but based on what I have heard from fairly reliable sources, his removal would be a testimony to a very, very serious attempt on the part of the government to try to prevent corruption.

This man had access on a regular basis to the Premier, Zhu Rongji. I mean, he appeared to be to all of us a seminal figure. The only analogy I can give you in this society would be if the FBI 15 years ago arrested Walter Riston because of failure to have good disclosure.

So again, this is a sign perhaps that the Chinese authorities are trying very, very hard and going after people that all of us would have thought 2 weeks ago would be invulnerable to this kind of pressure.

But again, it is an ongoing process. We have very, very divergent stories. We have sectors in China that are now trying to raise money for the first time in their history. The telecom sector in China is going through profound regulatory upheaval from being a state monopoly to having a number of competing firms.

Because everything is so new and so path-breaking, you will have problems. The fact is many of these companies didn't exist 3 or 4 years ago. They are being carved today out of huge monopolies that have been there for half a century.

Commissioner ROBINSON. That is very interesting, and I would be interested if there are any other observations there—but do you have any observations on Huaneng Power, or did you see that recent Post piece on nepotism—I think Marc Pottinger might have been the author's name.

Mr. HALE. I did not see that piece. Huaneng Power has been a popular stock for foreign investors.

Chairman D'AMATO. Li Peng's family.

Commissioner ROBINSON. Yes.

Okay. We'll reserve that——

Mr. HALE. I'm sorry, I did not see The Washington Post.

Commissioner ROBINSON. It is an interesting piece of a firm that is already listed.

Are there any other comments?

[No response.]

Thank you very much.

Chairman D'AMATO. Thank you, Commissioner.

Commissioner Dreyer?

Commissioner DREYER. Just quickly because I've got to catch my plane—but the pessimist response to Mr. Hale's comment that firing this guy shows the strength of the system is that it doesn't at all; it just shows that his "guangxi" wasn't as good as his connections—he didn't keep up with connections. So you are the optimist, and I presented the pessimist.

For Dr. Overholt, you rightly point to the health of the Korean banks relative to some years ago after they went through a problem, but I am wondering, since it took such a financial crisis to get the Korean banks to clean up their act, do you anticipate such a problem with Chinese banks before they do?

I know that a lot of people have predicted—not just Gordon Chang, but others—that there is a financial crisis in the offing.

Mr. OVERHOLT. What is impressive about the Korean, Thai, and Indonesian cases is that they said there was no cliff out there until they were halfway fallen off the cliff.

What is impressive about the Chinese case is that back in 1993, 1994, and 1995, even people like Li Peng were saying we've got a very serious crisis here. Our state enterprises are in bad shape, our banks are in bad shape, and we have got to do something about it.

And the counterpart of Korea's laying off 38 percent of its bankers is China laying of 55 million people.

So yes, they have a mega problem, but they have chosen to proactively address it.

Commissioner DREYER. In other words, they are trying to address it with the cliff in sight rather than halfway off the cliff.

Mr. OVERHOLT. Yes. And the hole is very deep, but their national finances are in much, much better shape, for instance, than Japan's. You mentioned the Gordon Chang piece. He took every number for their government liabilities and stretched it to the max, and he came up with about 140 percent of GDP. Goldman Sachs' effort to be balanced comes up with over 400 percent of GDP for Japan.

China's ability to collect taxes is not nearly as great as Japan's or other developed countries, so they are skirting the edge. But what they have done is quite impressive, and financial markets tend to treat people who are open about their problems and do major things about their problems rather generously.

The risk to China is management. They have a major management change coming up. If they were to go for 2 years with weaker management, the markets would lose confidence, and they would be in all sorts of trouble very fast. The state enterprises would go backward, the banks would get into very serious trouble, and even the environmental issues would go critical very quickly.

So the good news is that they have had heroic management. The bad news is that the next 5 years, they can't go for 18 months without heroic management. And as we all know, that's tough.

Commissioner DREYER. Thank you very much.

Chairman D'AMATO. Thank you very much, Commissioner Dreyer.

Commissioner Ledeen?

Vice Chairman LEDEEN. Thanks to all of you.

We have had a lot of great panels today, but this one is really uniquely good, and it has really been a pleasure.

Could I just pick up on what June Dreyer was saying, but I would put it a little differently. Someone who didn't agree with you, Mr. Hale, or wanted to just have fun with what you were saying, might say that's not an anti-corruption campaign, that's a purge. For someone like me who has worked in Italy for the last 30 years, any such event in Italy is instantly recognizable as a purge since no one takes seriously the idea that there will be a serious anti-corruption campaign over time that will produce a society without corruption, in which they don't believe anyway. And my impression of China is that the Chinese don't believe in the possibility of a non-corrupt society, either, although maybe that is wrong, and I would like to hear your opinion on it.

Well, if it is a purge, then what we are talking about in such cases is internal balance of power and political maneuvering and things like that, and that is fine with me, because I don't believe that poverty brings down regimes, and I don't think that economic crisis produces revolutions. That is the conventional wisdom, but I have never seen one since the French Revolution that worked that way. And in the modern world, generally, things come down when the ruling class has a failure of nerve, a failure of will, isn't willing to repress anymore, isn't willing to fight for its own power. I don't see any sign that that is the case in China.

Anyway, those are my thoughts.

Please.

Mr. HALE. First, just to challenge your assumption, I think you are not being fair to the Italians. In 1992, there was a judicial inquiry by judges in the land that led to the arrest of two-thirds of the members of the Italian Parliament, and in the months that followed, hundreds of the country's leading executives, with the result that in 1994, there was a prison on the outskirts of Milan where every day, The Financial Times delivered 100 copies.

Vice Chairman LEDEEN. Mr. Hale, please don't tell me about Italy. There were two convictions out of 300 arrests. It was a pure purge—it was pure politics.

Mr. OVERHOLT. Can I have a go at this?

Vice Chairman LEDEEN. Yes, please.

Mr. OVERHOLT. You are right——

Chairman D'AMATO. Is that Italy or China?

Vice Chairman LEDEEN. Italy. I don't know about China.

Mr. OVERHOLT. I'll have a go at China. Any individual event can be either an anti-corruption campaign or a purge. What we have seen in China is that they published a study last year that said that over 90 percent of companies on the stock exchange that they investigated were misreporting their financial results, and in over 80 percent of the cases, it was clear fraud.

The numbers are shocking. The interesting thing is that they published them, and they published them because they think that is the way to get rid of corruption. And when you are talking about 80 percent of the companies, it is not a purge, it is a campaign.

They have done this in other areas. They decided to get the military out of business, or mostly out of business. It was an anti-corruption campaign. When they did that, they started at the beginning of 1998, and by April of 1999, food and beverage imports were up 40 percent in a weak economy.

I remember digging into that—why are the Chinese eating 40 percent more when the economy is getting weaker—it turned out that what they had done was put world history's biggest smuggler, the People's Liberation Army, mostly out of business. And that was one key to getting government revenues up from 10 percent at the bottom to about 14 percent today.

Now, having done these things (and these are big things; you [Commissioner Ledeen] have done work on places like Thailand and Indonesia where they could never get the military out of business) they are still just scratching the surface of corruption in China. But they are serious; it is a campaign.

Vice Chairman LEDEEN. Thank you.

Chairman D'AMATO. Thank you very much.

Commissioner Waldron?

Commissioner WALDRON. I would like to ask about something which isn't really precisely what we have been talking about. What we have been talking about is the foreign role in China and the rosy or not rosy prospects for foreign banks, foreign insurance companies, and so forth and so on. But in the course of that, it has also emerged that nearly all the stocks that are traded in China are not really stocks in private companies at all, but they are packages of state assets which have been put together and in which there is no market for control; they are only minority partners.

It has also emerged that 55 million Chinese have lost their jobs, or at least have left state enterprises or rural enterprises.

Now, it seems to me that we have to ask the question of whether, in addition to improving the climate for private foreign business, China's Government is doing anything to improve the climate for private Chinese business, because my own belief is that the only conceivable way in which they are ever going to be able to deal with the population and labor problems and all the rest is to unleash the power of Chinese entrepreneurship. And the way that works in most countries is that somebody can start a company, and they can have stock in that company, and then, when they become enormously rich, they can sell out, they can cash out, they can sell control of the company, they can sell the stock, and then they can take all of that money and give it to somebody while they go off and live in Hawaii, and that person then recycles the money to other entrepreneurs. It is this cycle that has made free market countries rich.

What I would like to ask is do we really see any signs at all of this happening in China. When I look at the Chinese economy, what I see by and large is a state sector that is trying very hard to get itself back in shape, with a lot of assistance, using a lot of foreign money and a lot of know-how, but I don't see any particular understanding of the need to create a favorable business environment for actual Chinese businessmen and entrepreneurs.

And if you look to the figures for capitalization loans and all the rest, I think what I have to say is borne out. I would be very interested in the thoughts of all three of you. Do you think that in 10 or 20 years' time, we are going to have a truly private free enterprise economy, or are we going to have something like one of the earlier speakers described the Chinese system today as being essentially fascist or corporatist. I think that that describes rather well what the government is trying to create.

Commissioner LEWIS. Arthur, excuse me. That was political, not economic. You were asking an economic question.

Commissioner WALDRON. When I say "corporatist," I am——

Commissioner LEWIS. But the word "fascism" was political.

Commissioner WALDRON. It was political, yes, but fascism was a ray of running an entire society, including the economy. It was different from communism in the way that it approached economics. It formed cartels and so on. This is a detail that we can go into.

I know that as soon as I use the word "fascist" in connection with China, of course, that is a red flag word, so let's not use it.

Let's just say what are the prospects of an ordinary Chinese entrepreneur—the figures in the Chinese paper the other day said that the party officials owned 70 percent of China's wealth. Did they get to own 70 percent of China's wealth in the way that I have just described, or did they get to own 70 percent of China's wealth by appropriating it?

Mr. OVERHOLT. The Chinese have moved farther in the direction you say is desirable, or at least faster, than any country in the past century, for sure.

The state enterprise sector is down to about 25 percent of GDP. There is hardly any——

Commissioner WALDRON. What about of investment? I know the percent of GDP is down, but if I am not mistaken, the actual investment into the state-owned enterprises is rising; is that not correct?

Mr. OVERHOLT. The percentage of bank loans is way down; it has been cut almost in half. They changed the Constitution to put the private sector on an equal basis. They removed discriminatory laws. There are all sorts of discriminatory taxes, land use rules, and other things. They required the banks' by-laws to allocate certain parts of their capital and certain portions of their personnel to fund private corporations, like it or not.

What you have in China today is one of the four entrepreneurial societies in the world. I would say those four are the United States, Hong Kong, Taiwan, and China. You have had this incredible burst of entrepreneurship in the rural areas; it created 110 million jobs in a decade. If you go to Shanghai or Shenyang the outskirts of Beijing, what you see going on is very similar to Silicon Valley. This is what didn't happen in South Korea until the crisis. It is starting to happen on a smaller scale proportionately than China. It hasn't happened at all in Japan. China is just way, way far down the road you want them to travel.

Mr. HALE. We have had great victories, as Bill just indicated, and also some setbacks. I think Bill is broadly correct that the private sector has accounted for much of China's growth in recent years and now employs large numbers of people.

I would also say that the analogy with Korea is appropriate. Korea 10 years ago was dominated by 30 or 40 chaebols. Today, 10 percent of all Koreans work for a firm less than 3 years old. The equivalent number of this country is 4 percent; for Japan, it is 0.5 percent.

So Korea is a very good role model for this transformation from corporatist, very much state-driven development, through the banking system being controlled, to having something entrepreneurial and free market.

The new issues that concern me in China center on the banking system and the stock exchange. We had plans a year ago this autumn, a few months ago, in September and October, a new stock exchange in Shenyang for the private sector. That was deferred, and we just don't know how long it will be deferred. But had that gone forward, in my opinion, it would have been a very exciting development, because you would have an opportunity for hundreds of private companies, not state companies, to go public and raise capital and so on.

These companies can still do that by going to Hong Kong. The gem market is overwhelmingly Chinese. And a few have come to NASDAQ or gone elsewhere in the world. But the fact is China needs to create a stock exchange for its private sector because only about 30 or 40 of the companies in the current stock exchange in Shanghai are truly private. I would add that those companies have significantly outperformed the state companies, so they do prove that entrepreneurs can do well when they get access to the market.

In the case of the banking system, we also have to have a major reallocation of resources away from the state companies to the private sector. As recently as 5 years ago, the Chinese banks had no history or experience making loans to the private sector. They are now getting that gradually. There are several new banks, still state-owned but also going public on the stock exchange, launched in the last 5 years which are focusing much more on the private sector—Mingshang and Pudong Development Bank and so on.

So the transition has begun, but we have further to go, and I will be very disappointed if, in a year's time, we don't have a major breakthrough in creating the stock exchange for the private sector. I think that could play a very useful and very important role in driving this process forward.

But the fact is there is a capital market in China which is also informal, through family, friends, and personal relationships, and there is access to capital through that informal market. And China has a very large savings rate, almost 40 percent, so there is lots of liquidity in the system. Returns on assets in the banking system are minuscule—1, 2, 3 percent—so I think there are plenty of opportunities for people to allocate capital to the private sector just through personal relationships and what I would call personal networking.

Commissioner WALDRON. What about the problem of regulation? I don't want to get anecdotal, but there are lots of examples I know of really fine Chinese entrepreneurs who are able to get hold of the capital, able to train the personnel and so forth, just the way that you have described, and then the authorities simply come in and say, "What you are doing is illegal," or they demand a payoff or they demand a sort of mafia-style equity share. I think this is also a problem.

I would also point out that in your answer, which I think is a good answer, the very fact that one talks about informal capital allocation mechanisms indicates that a great deal of capital is being misallocated through the state banking system; vast amounts of capital have been wasted. And if one considers what China would be absent the very strange socialist, state-owned system, this has held it back terribly, and it continues to do so.

Mr. HALE. The answer is that there are lots of examples of the government—individuals in the governments, bureaucrats or civil servants—using their powers for self-enrichment, and administrative discretion over some aspects of regulation will always be a problem.

But again, the hope is that as you create a stronger civil society and more rule of law, that will erode. I would say there is less of that today than there was 10 years ago, but the situation is far from perfect, and it happens incrementally.

Let me again tell you a little bit about this informal network. I had dinner a few months ago with a friend who is now buying state-owned companies and restructuring them. Ten years ago, he was a political prisoner. He was arrested after Tiananmen Square because he ran a newspaper in Shanghai that was very critical of the government. When he got out, he couldn't get a job for a year because he had been a political prisoner. But now, he is one of the most successful merchant bankers in Shanghai, buying state-owned companies, restructuring them, and doing the dirty work.

I said to him at dinner, "The survival of the Communist Party of China, Mr. Chen [phonetic], now depends on you, because if you don't restructure these companies effectively, the whole system will implode," which I think Mr. Gordon Chang told you probably a few months ago as well.

What can I say? It is not perfect, there are lots of problems, but there is a great deal going on, which is encouraging as well, and the challenge on a one- or two-year deal will be to further institutionalize this movement of capital into the private sector through the new stock exchange and through these new banks, which are more privately focused to have a larger share of the lending.

The problem with the state-owned banks is they are basically not "banks" in our sense of the word; they really are there to provide subsidies to the state-owned companies. That is all they did 5 years ago, and now it is half of what they do, and hopefully, in 5 years, it will be 10 percent of what they do. That is the price of maintaining social stability in a country going through a very profound transformation. I'm not sure you could go any faster without having high levels of unemployment and a lot of social instability. Indeed, if China had a democracy today, the risk is that people might vote to stop the economic transformation because it is so disruptive of traditional ways of doing things and does create the risk of economic insecurity. So it is a slow-motion process, but the important point is what Bill said a minute ago. The trend is still very much in the right direction.

Chairman D'AMATO. Thank you.

Commissioner Mulloy?

Co-Chairman MULLOY. Thank you, Mr. Chairman.

I'm going to quote something from Mr. Hale's testimony, and then, if each of you would comment on the question that comes from it.

Mr. Hale, in your really helpful testimony, you point out that "The cumulative level of FDI in China since the 1980s is about

$400 billion." I think their economy is about a trillion-dollar economy?

Mr. HALE. That's correct yes.

Co-Chairman MULLOY. So $400 billion. As a result, China has a stock of FDI surpassed only by the United States and the United Kingdom. In other words, the stock of FDI in Britain was about $394 billion, compared with $225 billion in Germany, $164 billion in Brazil, $79 billion in Singapore, $65 billion in Indonesia, and then you point out that in Korea, it is about $28 billion and in Japan about $39 billion.

Mr. HALE. Yes.

Co-Chairman MULLOY. This is a huge—$400 billion. And that is at the rate now of about $40 billion a year, we were told when we were there, and they expect it to increase maybe to $100 billion a year.

Mr. HALE. Goldman Sachs in Hong Kong is forecasting that in 2005.

Co-Chairman MULLOY. Yes, in about 5 years, about $100 billion a year.

Now, we were told, again, that half of Chinese exports are made by joint ventures or foreign-owned firms, and we are running an $85 billion deficit, so if you get $100 billion in there instead of $40 billion a year, they are going to get a lot of foreign investment very quickly, and we went there and saw it—they are really building a first-rate economic base.

Mr. HALE. Yes.

Co-Chairman MULLOY. And some people commented this morning that one of the reasons they wanted to get into the WTO was to guarantee that this foreign investment would keep coming. By joining the WTO they have locked other people's markets open because you have now got to go through the WTO to make your complaints.

So there is a question here—and the financial services guys were very much in favor of the agreement, of the WTO PNTR, because they said "We are going to get a lot out of it."

Now, politically, if we are talking to people who are going to be impacted by the stuff coming from China, what is it that this industry is going to get in China that feeds back to ordinary Americans and makes this whole gamble worthwhile?

Mr. Overholt, and then Mr. Hale and then Mr. Shoyer—what is it that this industry is going to get to help defray some of the costs that we are going to pay?

Mr. OVERHOLT. First of all, I don't think this particular financial industry is going to pay any particular cost in connection——

Co-Chairman MULLOY. No, no—but manufacturing and the other guys in the commercial sectors may.

Mr. OVERHOLT. The world hasn't suffered terribly from the fact that we get five or six times the amount of foreign direct investment that China does. It doesn't mean that we take over everything.

They get foreign investment in the things that they are good at, which are labor-intensive things, and what has happened in the past decade is that because we have restructured in a way that countries like Japan haven't, we have let the stuff that the Chinese should be doing go to China, and they are making shoes and shirts and so on, and we have focused our energies on the things we have been good at. We have had the lowest unemployment rate in our modern history. We have had the highest economic growth rates. We have had the longest economic boom. And a lot of that was because of China.

Why didn't the Fed have to kill this boom off early? Because inflation was low. Inflation was low partly because of productivity increases. It was low partly because all the cheap shoes and shirts and so on coming from China prevented shortages and kept prices low so that the boom did not cause inflation.

The fact that we did our restructuring in the eighties in response to Japanese and Korean competition essentially let us take over a huge chunk of the world economy. Our adjustment to China's just continues those same changes.

We complained bitterly—our textile industry was being hammered by the Koreans, and the Taiwanese and the Japanese were destroying our steel and car industries and so on. We took the heat, and the nineties were the result; we got huge benefits. And to the extent we continue doing that, we are going to continue to be on top of the world. And you see what happens when you don't do it. Look at Japan today. In 10 years, they have gone from being king of the world to just a catastrophe. It is because they protected their industries and didn't go through this adjustment.

So I think we are benefitting enormously, and I think we will benefit in exactly the same way going forward.

Co-Chairman MULLOY. Mr. Hale?

Mr. HALE. It is part of a process that goes back to the Industrial Revolution beginning in England in the 18th century. We have had an extraordinary growth of world trade over 200 years. The growth of world trade since World War II has been very dramatic. In that process of expanding trade, there are always going to be new winners and losers—industries that can't keep up, industries that aren't price-competitive, industries that fall behind because of inadequate technology—and China is simply the latest chapter in this story and it goes back 200 or 300 years.

I think the opening of China and the integration of China into the world economy will create for us lots of export opportunities, certainly in capital goods industries, over time as well as in consumer goods industries as their incomes rise, and there will be a two-way flow of trade.

Clearly, because of their low labor costs and relatively good levels of productivity, with foreign investment and foreign management, have captured a very large market share here in the last 10 years. As Bill indicated, the benefit for us has been a very low inflation rate. Alan Greenspan was able to preside over a great stock market boom for 3 or 4 years in part because he didn't face the kind of inflation rate he might have faced 15 or 20 years ago. When the boom finally ended, it wasn't because of China, it was because of speculative excesses in our telecom and technology sectors where we made some bad investment decisions on the basis of changes in government regulation of the telecom sector that were not fully understood or fully comprehended on Wall Street.

It was not China—it was our own internal contradictions that set the stage for the slowdown.

So my vote is that we continue this process which is 200 years old, we keep experimenting with free trade and with further integration of countries into the system, and if we continue, I have no doubt that we have enough in terms of our powers of knowledge and technology creation to be competitive and to be winners. But it will be a constant struggle, and there will always be winners and losers, and we have to respect the losers by looking after their interests and creating a safest net for them and try to work hard to produce the winners and to make sure we allocate resources efficiently so the winners can go out and take advantage of the opportunities.

Co-Chairman MULLOY. Thank you.

Mr. Shoyer?

Mr. SHOYER. I would only add that one of the things that the WTO does is to subject protectionism to process. WTO rules do not constrain it or eliminate protectionism entirely. There are clearly going to be losers in China's economy. How sympathetic our financial service industry is going to be to less efficient Chinese competitors remains to be seen. We are obviously in there to win. But we'll have to be careful to demonstrate sufficient understanding of the dislocation in the Chinese market and the plight of the losers in struggle for market share. We can't create such ill will that it impedes our ability to move forward.

Co-Chairman MULLOY. Thank you.

Chairman D'AMATO. Commissioner Lewis?

Commissioner LEWIS. Mr. Hale, I just have a factual question I want to ask you. You mentioned the percentage of foreign ownership of banks in Poland and Hungary.

Mr. HALE. Yes.

Commissioner LEWIS. Do you know the percentage of foreign ownership of the banks in Korea?

Mr. HALE. It is much more modest. Two years ago, the Korean Government sold one major bank to foreign investors. It was supposed to sell a second, but that deal then collapsed. Now they are once again negotiating to try to sell that bank, but the deal has not closed. In addition, Commerce Bank of Germany owns about 40 percent of one of Korea's largest banks, the Korea Exchange Bank. So whereas there was no foreign investment in Korean banking 5 years ago, the system has begun to open up, but it is still——

Commissioner LEWIS. What would you say—20 percent, 30 percent?

Mr. HALE. I couldn't give you precise numbers, but somewhere between 10 and 20 percent would be approximately right, and because of the large minority shareholding in Korea Exchange Bank, it might even be a bit larger, but still it is a minority shareholding.

Commissioner LEWIS. Thank you.

Mr. HALE. Let me add, though, that foreign investors have fallen in love with Korean Bank stocks, and one of the major Korean bank stocks, Koopman Bank, with $6 billion in assets, is now listed on the New York Stock Exchange, and I think foreign institutional investors own 20 or 25 percent of that.

Commissioner LEWIS. And Commerce Bank owns 40 percent of the Korean——

Mr. HALE. The Korean Exchange Bank, yes. And there is one more big bank still for sale, and who knows—we may eventually sell that to the Hong Kong and Shanghai Bank or someone else.

Commissioner LEWIS. The other question I wanted to ask you is if the Chinese currency is pegged 8.3 to the dollar, and the dollar has appreciated over the last several years, in essence, hasn't there been a revaluation of the Chinese currency?

Mr. HALE. Both the Hong Kong dollar and the RMB, which are pegged to the American dollar, have appreciated, and this has been a source of concern to Chinese manufacturing companies, and it has been a source of deflationary pressure in China itself.

As you know, Argentina was also pegged to the American dollar until last week, but finally, because of the competitive pressures being so great, they had to succumb to a devaluation.

Commissioner LEWIS. I'd like to ask Mr. Overholt a question. You said that there has been the lowest unemployment rate in the last several years here, as if free trade in Chinese goods has helped this. We were on a commission that dealt with the trade deficit, and this statement was made by some people who were hard advocates of free trade, and Lester Thurow's response to that was that that really doesn't mean anything—the question is wages. His point was that in the last 30 years, 80 percent of America has lost ground in wages up until the last 2 years of the Clinton Administration, so that even though we have a low unemployment rate, if 80 percent have lost ground, maybe it hasn't really been that good.

I'd like your response to that.

Mr. OVERHOLT. I have just come back from 16 years in Hong Kong, so I am not as current with U.S. wage numbers as Mr. Thurow is.

Commissioner LEWIS. I mean, zero unemployment doesn't really mean anything.

Mr. OVERHOLT. I doubt very seriously that 80 percent of Americans are poorer after the 10-year boom that we have had. I suspect maybe David or Mr. Shoyer has better data.

Commissioner LEWIS. The only point I'm making is that unemployment isn't really the factor—it's wages.

Mr. OVERHOLT. The worst kind of social deprivation is not having a job. This is the worst thing that can happen to society is to have high unemployment. So employment is the most important thing.

Now, if you look at manufacturing wages in an economy where it is the service sector, finance, high-tech, that is expanding, and manufacturing is trailing edge, then some manufacturing wages are going to decline.

Commissioner LEWIS. But the argument that he was making was that the movement of jobs overseas by factories that just pick up and move overseas and the threat that that has on the negotiations here for wages have caused a drop in wages in the United States.

Mr. OVERHOLT. In declining industries, I am sure that is true, but I can tell you, in investment banking and making computers and so on, we Americans are getting rich at the kinds of things that we Americans are good at.

Commissioner LEWIS. Well, even at making airplanes—Boeing is moving some of their stuff overseas now, too. China says "If you want to sell us planes, you have to build part of them here in China."

Mr. OVERHOLT. They build them where it is most efficient. What we are good at, and what pays really high wages, is designing airplanes and marketing airplanes and financing airplanes. That's where the big money is. That's why we are in the sector we are in.

Commissioner LEWIS. I'd like to ask Mr. Hale another question.

Mr. HALE. Let me just rephrase what he said. My understanding of the data is not that 80 percent of all Americans have had wage declines in the last 20 years; the wage declines have been very much concentrated in unskilled workers, high school dropouts. College graduates in fact have had rising real incomes, and high school graduates are somewhere in the middle.

Moreover, one of the major causes of this pressure on wages is not foreign trade—it is immigration. We have taken in 10 million immigrants legally and many more illegally, and this really has depressed wages at the bottom end of the scale for service jobs and restaurants and hotels and so on. This is again just a reflection of our culture being very open and willing to accept high levels of immigration.

Commissioner LEWIS. In regard to the economic interdependence of Taiwan and China, do you see a way that that issue can be resolved?

Mr. HALE. Well, the answer is that it is being resolved in the marketplace. The Taiwan corporate sector is investing massively in China. About $40 billion of that, $400 billion of FDI in China, is from Taiwan—some say it is 50 or 60, but it is at least 40 or 50; we know that from the data. And whereas 10 years ago, it used to textiles and shoes, now it is increasingly high-tech. And if you look at every Taiwan technology company, they now have a third or a quarter of their output in the mainland, and some will be even higher in a few years' time.

Commissioner LEWIS. Do you think this will lower the threat of an armed confrontation?

Mr. HALE. Well, I think we have the problem that Taiwan is ambiguous. Taiwan does not want to be a part of China in a political sense, but yet it knows it is part of China economically, and maybe over 50 to 100 years, if China becomes a more plural society on the mainland, there can in fact be a reintegration—but that is still in the future.

I think the vote for the DPP shows that people want some independence, but they also don't want to have a declaration of independence that would then provoke China in a military sense.

So I think we are going to continue with ambiguity for a while. But all the recent gestures by this government have been to enhance integration. There was a government task force in the summer that recommended the end of the restrictions right now, for example, on air and sea traffic, and that may come in the new year.

So I don't see anything stopping the economic integration of the mainland and Taiwan.

Mr. OVERHOLT. If I could come in on that, one part of the Taiwan-China problem is the Lee Teng-hui argument. We haven't known you guys for 50 years. We are a completely separate culture now. We don't have anything in common.

That is just one part of the problem, but that part of the problem has been resolved because about 10 percent of the Taiwan work force has migrated to the mainland.

Mr. HALE. That's right.

Mr. OVERHOLT. And there is lots of interchange. So that one problem is going to be completely solved, assuming that they don't decide they hate each other because they have learned more about each other—but that's not the way it is working. A lot of the Taiwanese (I just took two major investor trips through Taiwan companies on the mainland) say, "We aren't going to go back. Life is better here. Opportunities are better here."

Mr. HALE. The best-selling book in Taipei this year—or last year—is "How to Live and Work in Shanghai."

Chairman D'AMATO. We're going to have to move on.

Commissioner LEWIS. Thank you.

Chairman D'AMATO. The next questioner will be Commissioner Reinsch.

Commissioner REINSCH. Just very briefly—you have already said this, but I want you to say it again, because I thought you were right. While I think the point that one of you made that any individual event can be analyzed from multiple points of view and attributed to a variety of causes, I think what is particularly relevant is the trend, and you have more or less suggested, all of you, that the trend here is positive from the standpoint of the portfolios that you have and the perspective that you are looking at it from, and that in essence, we are talking about a trend that is maybe two steps forward and one step backward, rather than the other way around.

I guess my question is simply is that right, is that what you are saying? Can you foresee that continuing for the medium to long term?

Mr. HALE. I think both Bill and I believe that the trend is in the right direction, but it is not going to be overnight—it is going to be incremental and gradual—and there will be U-turns, and there will be examples that run contrary to what we are saying from time to time. But I think we really do feel that on a 10- or 20-year view, China will have stronger institutions, more rule of law, more transparency, and more convergence with the kind of way of life and the world we know in our society. But it will not be 100 percent, and it will be incremental, because there is no alternative. The fact is China cannot be a modern economic power, and it cannot really achieve a high living standard if it doesn't have the rule of law, it doesn't have transparency, it doesn't have corporate governance that is consistent with our principles. You just can't operate at the end of the 20th century or in this new millennium a market economy if you don't have those fundamental principles. You just can't do it. It is impossible.

Commissioner REINSCH. Mr. Overholt, I take it you agree with that?

Mr. OVERHOLT. One hundred percent. It is absolutely necessary; the current leaders understand that it is absolutely necessary. The new generation—each time you go to a younger group, they get more reformist, not less.

The big uncertainty is whether they will have the leadership clout to continue these painful efforts. What they did when they put Zhu Rongji in office was like making Paul Volker President of the United States. It is a decision you don't take lightly. And he doesn't care whose toes he steps on, and everybody knows there is such a big problem that you had better let him do it—unless he really screws up.

It takes a really big stick to keep these interest groups under control. To make it concrete, every few weeks, you see the Minister of Information Technology say something like, "We aren't going to let any encryption into China unless it is our encryption," and a few weeks later, somebody gets to Zhu Rongji and says, "You know, that means there is going to be no internet commerce in China," and Zhu Rongji takes out his big club and hammers down the Minister. It's like that game where you have a hammer and you have to hammer down muskrats as they pop up.

It is not a completely foregone conclusion that whoever comes into that job will continue to have the degree of support that he will be able to hammer down the muskrats. My best guess is that it will continue, but it wouldn't be responsible for somebody like me to sit here and not point out the risk, particularly when we have the issue of transition coming up, starting at the end of this year. This is the crucial one. If they make it through the next 5 years, they are probably going to make it, the way Taiwan and South Korea did. It is the same process. But if they don't, everything will go wrong at the same time, and then all of us China optimists are going to really, really look bad.

Commissioner REINSCH. Thank you. I think the irony, among other things, is what Mr. Hale alluded to—that to the extent that these things are happening, it is probably helping the regime rather than hurting the regime, which is an irony.

One final question is what should the United States Government be doing to further facilitate this that it is not already doing.

Mr. HALE. Well, I think we have engaged in a very useful engagement with China over the years about a wide range of issues, from our security concerns to human rights to Tibet to Taiwan's economy, and we just have to continue with that process and hope that the process of change in China itself will prove that it is in convergence with our values.

I think the current leadership transition is important because this is the fourth generation since the Revolution, and these men will be coming in after 20 years of economic liberalization. But I think the next transition in 2008 or 2009 will be the most important, because then you will have literally at your disposal hundreds of thousands of people with foreign university degrees, a large number of whom speak English and have lived overseas, and I think this will be the most radical generation in all of China's histories in thousands of years, because they really will have very different values and very different experience. But they don't take power until 2008 or 2009.

We have dealt with these people when we are in Beijing and Shanghai; they are currently in their late forties, early fifties, but they need 5 or 10 more years to take power. And then, I think all the current suspicions and all the current fears will fade very quickly, and you will see in China a kind of pluralism. It may not be exactly like Korea and Taiwan today, but it will be in that direction, and that will open the way, I think, to very radical changes in attitudes and habits and everything. But we need more time. This whole process takes time. You can't take a country after 30 years of Communism and change it over night, especially if that country was before quite backward and had all kinds of other structural problems.

Commissioner REINSCH. Thank you, Mr. Chairman.

Chairman D'AMATO. Thank you very much.

This has been a terrific panel. There is one thing that you didn't mention as one of your recommendations that I want to point out, Dr. Overholt. In the section titled, "What Can We Do?" you say that "Chinese leaders are counting on us to keep the pressure on," and then you say that we should be training a lot of Chinese lawyers.

What we could do is we could go down and put a couple of jumbo jets full of 16th and 17th Street lawyers, load them up and sent them over there. That would help the United States and help Washington, D.C. quite a bit, too.

Mr. OVERHOLT. Absolutely—and improve the trade balance.

Chairman D'AMATO. This has been a terrific panel. Thank you very much.

We'll take a 5-minute break and then begin our next panel.

PANEL IV: ENTERTAINMENT INDUSTRY AND INTELLECTUAL PROPERTY RIGHTS

Chairman D'AMATO. The second panel of this afternoon will examine the landscape for the U.S. entertainment industry in China and the key issue of China's compliance with its intellectual property rights commitment under the WTO.

With regard to entertainment products, China made two important commitments as part of its WTO accession. First, it agreed to allow greater foreign investment in this industry and to raise the quota on foreign films that can be distributed. In addition to these market access concessions, China agreed to fully implement the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights, known as the TRIPs agreement.

China's willingness and ability to comply with its IPR commitments will be a key test of its willingness and ability to meet its WTO obligations. Some reports suggest that the vast majority of foreign audiovisual products and computer software presently sold in China are counterfeit, despite years of promised enforcement efforts. Effective enforcement of copyright, trademark and patent laws will require China to develop the requisite legal and administrative institutions and to commit the necessary resources to handle this complex task.

To discuss these important issues, we have Bonnie Richardson of the Motion Picture Association of America; Larry Spiegel, President of Appledown Films from Los Angeles, an independent production company; Eric Smith, President of the International Intellectual

Property Alliance; and David Quam, General Counsel to the International Anti-Counterfeiting Coalition.

I welcome all the panelists, and I will ask Mr. Spiegel to begin, and the rule will be 7 to 8 minutes, and we'll move down the table from left to right. We'll hear all of you first, and then we'll open it up to questions.

Mr. Spiegel?

STATEMENT OF LARRY SPIEGEL, PRESIDENT, APPLEDOWN FILMS, INCORPORATED

Mr. SPIEGEL. Thank you, Mr. Chairman, and thank you, members of the Commission, for allowing me to appear today.

I shall attempt to provide you with the perspective of an industry member but most certainly not a China specialist. I will leave it to my fellow panelists, who are expert in this matter, to delve into the intricacies of the China problem.

Webster's Dictionary defines "piracy" as "the unauthorized use of another's production, invention, or conception, especially an infringement of copyright." Webster also defines "piracy" as "an act of robbery."

So why not call it as it is? China it appears is condoning robbery on a grand scale. Think about it. While the Chinese Government has promised long and hard to protect intellectual property rights and continues to claim that pirated software will soon be a thing of the past, Business Software Alliance, an industry watchdog, reports that an estimated 94 percent of all the software currently in use in China is pirated, up from 91 percent in 1999.

Except for records and music, where an almost negligible decrease has occurred, for every other area of optical and media products—motion pictures, business software applications, entertainment software and books—the rate of piracy either remains static or rose between the years 1999 and 2000.

The loss in real dollars is staggering. According to the International Intellectual Property Alliance, more than $2 billion in the optical/media sector was lost to piracy in China in 2000, the last year for which complete records are available.

Two billion dollars. As deplorable as this figure is, what must also be addressed is the lip service currently being paid to efforts by the Chinese Government to reduce and/or eradicate the economic malignancy of piracy.

While press releases emanating from various sources, Chinese and other, uniformly laud this so-called effort, the IIPA raises the specter of a continued increase in China's production of pirate optical media products, including DVDs by licensed as well as underground CD plants.

Where does the truth lie? Hard statistics provided by any number of independent sources speak plainly—while Chinese claims to address this situation is just plain lip service.

Adding further concern is the growing sophistication of the pirate market, including the increasing production of high-end DVDs, as well as burgeoning internet piracy. It makes me wonder what harsher actions our own government might embark upon if, year after year after year, a couple of billion dollars were so blatantly purloined by the Chinese from our farm, manufacturing, or other hard-good exports.

And in reality, cannot the Chinese Government put an end to their own robber barons of intellectual property? China is, after all, a state in which the Communist Party reigns with impunity. When the rules in Beijing feel threatened by an internal source or get their fill of this group or that, they are infamous for cracking the whip. Surely they have the wherewithal to do so here. Then, why the lip service? Why the showboating?

Is it possible, just possible, that high party functionaries are themselves benefitting from the annual $2 billion plus windfall?

With specific respect to motion pictures, perhaps some practical examples might better illuminate the problem. According to Michele Delio, who filed this report for Reuters just a few months ago—and now I am taking the liberty of quoting from her piece—"The Grinch may be stealing Christmas on movie screens across America, but Chinese copyright pirates have already done him one better—they have stolen the Grinch here."

Within a week after the release in the United States of Dr. Seuss' "How the Grinch Stole Christmas," video compact discs of the film were selling on China's streets for about $1.20 each—further proof that China's well-oiled copyright piracy machine is running smoothly despite government promises to shut it down.

Ms. Delio goes on to say: "The video discs are mocking reminders of the difficulty China has carrying out agreements even as it prepares to enter the WTO."

In an August 2000 article in the LA Times, it was reported that pirate DVDs containing the George Clooney move "Three Kings" on one side and "Stuart Little" on the other were selling for about $3. The article went on to state that $2 pirated versions of "Gladiator" were for sale on Chinese streets soon after its U.S. release.

By far the most successful sale of a motion picture on legitimate video disc in China was the film "Titanic." Three hundred thousand copies were sold. That's a lot of copies. However, compare that figure to the 20 to 25 million copies of "Titanic" sold by video pirates, and the 300,000 figure suddenly seems paltry.

Even with less popular films, the pirates outsell legitimate distributors about 35 to one.

The impact of piracy not only significantly reduces revenues for motion picture studios, it has a direct negative effect on people—those writers, directors, and actors who work on films. Some have expressed the opinion that if a Tom Cruise or a Julia Roberts, who earn millions for each film, lose some thousands of dollars to piracy, what's the big deal? Well, besides the principle that stealing is just plain wrong, there are many, many writer, screen and director guild members who earn far less, some barely a living wage, and to whom the loss of royalty income, no matter how little, affects their lives in a very meaningful way.

Because of time, I am not going to in my verbal statement go into the theatrical release in China and the problem there and China's opening the theatrical film market to 20 films a year; it is in my written statement, and I stand by that statement, and I will go on to another section.

Can or will China meet its obligations under the standards set by the WTO agreement? According to a piece in the Internet Law Journal on March 8, 2001, and I quote: "China is going to struggle mightily to comply. A significant portion of its economy is based upon counterfeiting and the violation of virtually every intellectual property law known to the Western world. It is basically ingrained in China's economy and supported by the government in many of its various regions."

The foregoing barely scratches the surface of America's piracy problem in China. What can be done about it, and do we—does our government—have the resolve to stand up to this outrage and protect one of America's signature industries—an industry which Jack Valenti, President and CEO of the Motion Picture Association of America, rightfully calls unique—a melting pot of people much like America herself—an economic engine driving hundreds of thousands of jobs.

The motion picture industry, as well as those other American industries which have economic interests in China, cannot of their own accord force Chinese compliance on their own. And while I am not personally familiar with the avenues of recourse available under the WTO treaty, to rely solely on WTO compliance and/or the threat of WTO sanctions doesn't seem a near-term practical approach or solution.

Therefore, it is imperative that this Commission urge our government, in the strongest terms possible, to take a stand—a forceful, unflinching stand—and to do so now.

Piracy on the scale discussed here today has one and only one victim—the United States of America and the hard-working men and women who pay their fair share of taxes, play by the rules, and expect a fair shake in the marketplace.

[The statement follows:]

PREPARED STATEMENT OF LARRY SPIEGEL

Mr. Chairman, members of the Commission, thank you for inviting me to appear before you this afternoon. It is a great privilege for which I am most honored.

Those distinguished gentlemen and gentlewoman who are to testify after me will, I am certain, do so with eloquence and a depth of understanding of the intricacies of the China "problem" that I cannot aspire to match.

And so, I shall attempt to provide you with the perspective of an industry member but most certainly, not a China specialist.

Webster's Dictionary defines piracy as: the unauthorized use of another's production, invention or conception especially in infringement of a copyright. Webster also defines piracy as "an act of robbery."

So, why not call it as it is. China, it appears, is condoning robbery on a grand scale. Think about it, while the Chinese government has promised long and loud to protect intellectual property rights and continues to claim that pirated software will soon be a thing of the past—Business Software Alliance, an industry watchdog reports that an estimated 94 percent of all the software currently in use in China is pirated, up from 91 percent in 1999. Except for records and music where an almost negligible decrease has occurred, for every other area of optical media products: Motion Pictures—Business Software Applications—Entertainment Software and Books—the rate of piracy either remained static or rose between the years 1999 and 2000. The loss in real dollars is staggering—According to the International Intellectual Property Alliance, more than two billion dollars in the optical/media sector was lost to piracy in China in 2000, the last year for which complete records are available.

Two Billion Dollars—As deplorable as this figure is, what must also be addressed is the lip service currently being paid to efforts by the Chinese government to reduce and/or eradicate the economic malignancy of piracy. While press releases emanating from various sources, Chinese and other, uniformly laud this so-called "effort," the IIPA raises the specter of a continued increase in China's production of pirate optical media products including DVD's by licensed as well as underground CD plants. Where does the truth lie? Hard statistics provided by any number of independent sources speak plainly—while Chinese claims to address this situation is just plain lip service.

Adding further concern is the growing sophistication of the pirate market, including the increasing production of high-end DVD's as well as burgeoning Internet piracy.

It makes one wonder what harsher actions our own government might embark upon if year, year after year a couple of billion dollars was so blatantly purloined by the Chinese from our farm, manufacturing or other hard good exports.

And in reality, cannot the Chinese government put an end to their own robber barons of intellectual property? China is, after all, a state in which the Communist Party reigns with impunity. When the rulers in Beijing feel threatened by an internal source or get their fill of this group or that, they are infamous for cracking the whip. Surely, they have the wherewithal to do so here. Then why the lip service, why the showboating? Is it possible that high party functionaries are themselves benefiting from the annual two billion dollar plus windfall?

With specific respect to motion pictures, perhaps some practical examples might better illuminate the problem. According to Michelle Delio who filed this report for Reuters just a few months ago . . . and I'm now taking the liberty of quoting from her piece . . .

> "The Grinch may be stealing Christmas on movie screens across America, but Chinese copyright pirates have already done him one better: they've stolen the Grinch here."

Within a week after the release in the United States of "DR. SEUSS' HOW THE GRINCH STOLE CHRISTMAS," video compact discs copies of the film were selling on China's streets for about $1.20 each—further proof that China's well-oiled copyright piracy machine is running smoothly despite government promises to shut it down.

Ms. Delio goes on to say, "The video discs are mocking reminders of the difficulties China has carrying out trade agreements even as it prepares to enter the World Trade Organization."

In an August 2000 article in the Los Angeles Times, it was reported that pirate DVD's containing the George Clooney movie, THREE KINGS on one side and STUART LITTLE on the other side were selling for about three dollars. The article went on to state that two dollar pirated versions of GLADIATOR were for sale on Chinese streets soon after it's U.S. release.

By far, the most successful sale of a motion picture on legitimate videodisc in China was the film, "TITANIC." 300,000 copies were sold. That's a lot of copies. However, compare that figure to the 20 to 25 million copies of TITANIC sold by video pirates and the 300,000 figure suddenly seems paltry. Even with less popular films, the pirates outsell legitimate distributors about 35 to one.

The impact of piracy not only significantly reduces revenues for motion picture studios but also has a direct negative financial impact on people—those writers, directors and actors who work on films. Some have expressed the opinion that if a Tom Cruise or a Julia Roberts, who earn millions for each film, lose some thousands of dollars to piracy, what's the big deal? Well, beside the principal that stealing is just plain wrong, there are many, many writer, screen and director guild members who earn far less—some barely a living wage and to whom the loss of royalty income—no matter how little—effects their lives in a very meaningful way.

Can or will China meet its obligations under the standards set by the WTO's TRIPS Agreement. According to a piece in the Internet Law Journal (March 8, 2001) "China is going to struggle mightily to comply. A significant portion of its economy is based upon counterfeiting and the violation of virtually every intellectual property law known to the western world. It is basically ingrained in China's economy, and supported by the government in many of its various regions."

The forgoing barely scratches the surface of America's piracy problem in China. Now, what can be done about it? And do we—does our government have the resolve to stand up to this outrage and protect one of America's signature industries—an industry which Jack Valenti, President and CEO of the Motion Picture Association of America rightfully calls unique—a melting pot of people—much like America herself—an economic engine driving hundreds of thousands of jobs.

The motion picture industry as well as those other American industries which have economic interests in China cannot, of their own accord, force Chinese compliance. And while I am not personally familiar with the avenues of recourse available under the WTO treaty, to rely solely on WTO compliance and/or the threat of WTO sanctions doesn't seem a near term practical approach or solution. Therefore, it is imperative that this commission urge our government, in the strongest terms possible, to take a stand—a forceful, unflinching stand and to do so now. Piracy on the scale discussed here today has one and only one victim—the United States of America and the hard working American men and women who pay their fair share of taxes, play by the rules and expect a fair shake in the marketplace.

Thank you.

Chairman D'AMATO. Thank you very much for your statement, Mr. Spiegel, and the full statement will be included in the record.

We'll go right on to Ms. Bonnie Richardson from the Motion Picture Association of America.

STATEMENT OF BONNIE J.K. RICHARDSON, VICE PRESIDENT FOR TRADE AND FEDERAL AFFAIRS, MOTION PICTURE ASSOCIATION OF AMERICA

Ms. RICHARDSON. If I may, I'd like to start with a brief rebuttal of Mr. Spiegel's arguments. I agree with one fundamental fact that he has presented, and I disagree with virtually every conclusion he draws therefrom.

Yes, piracy on the domestic market in China is high. Piracy rates for our industry are down slightly this last year because of improvements in enforcement in three of the big cities—Shanghai, Guangzhou, and Beijing—but they are still in excess of 90 percent.

So, I agree with Mr. Spiegel that piracy levels in China are still high.

Where do I disagree with him? First of all, the trend is vastly improved. If you compare the current situation in China to where we were in the mid-nineties, China was the major source of export piracy, ruining world markets. China was one of the first, largest exporters and manufacturers of pirated optical discs, and now they are no longer exporting any significant numbers of piratical products. In fact, China is now the victim of the import of optical disc piracy from its neighboring countries—Taiwan and Malaysia. It is spreading all over Southeast Asia. We are seeing optical disc piracy now spreading to Thailand and to the Philippines; we are concerned it will spread elsewhere, such as Indonesia. The products are coming in over China's very large and very porous border.

We see no evidence that the Government of China is condoning piracy. Quite the opposite. In contrast to where we were in the mid-nineties, when the Chinese Government didn't believe or acknowledge that they had a significant piracy problem, now they will readily tell you that they have a significant piracy problem. Now they are working hard to get rid of it. We are working with them to that end.

There is absolutely no evidence today that there is any government collusion or organized attempts by the government to profit from piracy. Again, that is in contrast to where we were in the mid-nineties, when there was evidence that some organized groups in China with ties to the government were involved in optical media production. Those ties are not there today, at least not in any significant manner that we have been able to detect.

Regarding production of pirated optical discs—yes, there are still a few underground piracy plants in China, and the Government of China is doing everything it can to root it out. In the last year, they made raids and closed down six underground optical disc factories in China, and every time they find a new one, they take it out.

Harsher U.S. Government actions are not warranted to push China to take more aggressive anti-piracy actions. There is a role for the U.S. government to encourage and assist China in addressing its piracy problem. Already the U.S. Government is actively engaged in some of these activities. Training is perhaps the single most important thing the U.S. Government can do for example, training with Customs to improve the border enforcement to address the problem of a long and porous border, and the effects that imported piratical products are having on the Chinese market. Some assistance and consultation in legal reform as China adopts and updates its copyright laws and regulations to meet its WTO obligations would also be helpful.

Yes, unfortunately, the pirates do make more money in China than we do, and yes, the effect is harmful on the U.S. industry. Yes, it is harmful for U.S. creators; yes, we are working hard to address that problem. However, we are not the only victims. It is not solely America that is being hurt by piracy on the Chinese market; Chinese industries are also hurt. Chinese creative content is also being harmed in the Chinese market, and the Government of China knows it.

The Government of China wants to have a legitimate industry—a legitimate theatrical industry, a legitimate video distribution industry, a legitimate television industry—and they can only get there if they address the piracy problem on their own market. They have every financial incentive to address this problem.

Now for my affirmative presentation.

We have been in the Chinese market since the mid-nineties, since the first bilateral intellectual property agreement helped put in place a modern copyright law and then helped give China the incentive to address and confront its optical/media production problem.

The Motion Picture Association was given permission to set up its office in China in 1994. What have we learned from our relations with China?

First, we are absolutely convinced that when the Chinese Government makes a promise, it lives up to that promise. Yes, they are tough negotiators—absolutely, both commercially and on a government-to-government basis. But our experience is that when they make a commitment, that they do everything possible to live up to that commitment.

We are also convinced that, as in most countries in the world, the best way to do business is to establish relationships and learn to trust your negotiating partners, and then find ways of finding mutually beneficial activities in which to engage.

Therefore, as more of our films enter their market, we are also hosting film festivals here to introduce their products to our market. We are working to improve the efficiency and the viability of their film distribution system because it will help in the distribution of our films.

Our companies are investigating the possibilities of co-producing films in China. We are working together in building out their home video market.

Part of the piracy problem in China has been that the commercial channels for distributing films and entertainment product are underdeveloped. You can never fight piracy in a vacuum. There must to be a way to get legitimate products to customers that is at least as efficient and ubiquitous as the pirated distribution channels. We are not there yet in China, but we, and the Chinese Government and Chinese businesses are working toward that end.

It is a step-by-step process. We have to see what benefits us, and they have to see what benefits them.

I don't know what Mr. Spiegel's views were on theatrical market. We at the MPA think that the increase from 10 films to 20 films has been a helpful development, and we are seeing related spin-off that is benefiting us even as we speak. There is, for the first time, a real movement toward more competition in distribution. Historically, a single government entity has distributed films and home videos.

We are seeing at least initial thinking in China about allowing competition in film distribution. Again, this is not required by the WTO, but is part of thinking within China. So, the question should not only be how we can organize to make sure they live up to our WTO commitments, we also need to acknowledge they are taking steps unilaterally to improve access to their market.

So our conclusion is that piracy is a tough thing to fight in China, it is a tough thing to fight throughout Asia and Latin America. We are convinced the Chinese Government is trying, and we are convinced that the direction of change is in the right direction.

Thanks.

[The statement follows:]

PREPARED STATEMENT OF BONNIE J.K. RICHARDSON

Dear Mr. Chairman, Honorable Commissioners, I am pleased to have the opportunity to appear before you today to provide the views of the Motion Picture Association of America regarding our experiences in China, the lessons we have drawn from that experience, the impact of China's accession to the WTO on our industry, and our views on compliance.

The Motion Picture Association of America is a trade association representing seven major studios that produce and distribute filmed entertainment—theatrical motion pictures, home video entertainment and television programming—in markets all around the world, including in China. Our members include Buena Vista Pictures Distribution, Inc., (A Walt Disney Company), Metro-Goldwyn-Mayer Studios Inc., Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation; Universal City Studios, Inc., and Warner Bros, a division of AOL/Time Warner.

A Recent History of the American Filmed Entertainment Industry in China

American motion picture studios began moving into the China market after the U.S.-China intellectual property negotiations in 1994–95. Prior to those negotiations, millions of illegal cassettes and video compact disc (VCDs) of our member companies' films were being manufactured in China. This pirate product was being sent all over the world and seriously affected our industry's revenues in third countries. Needless to say, we were doing almost no business in China at that time because of the piracy and severe restrictions on our access to the market.

In the 1994–95 bilateral negotiations, the Chinese government pledged to shut down this illegal manufacturing. It backed this pledge with quick and decisive action against pirate factories—a step that many China observers had said would be politically impossible. The Motion Picture Association (MPA) was given authority in 1994 to open an office to help in the anti-piracy campaign and to establish channels for bringing in legal product. Top Chinese leaders looked to MPA to build a bridge of cooperation between the Chinese and American film industries.

That was the true beginning of our business in China. Factories illegally copying our films were closed. One such factory, a particularly large one, was rehabilitated as a partner for several of our studios making legal videos for the Chinese market. The export of pirated copies to world markets was brought to a halt.

Yes, there is more work to be done in fighting piracy on China's domestic market, where piracy levels remain high. There is also more to do in opening the market to legal product. However, much has been accomplished over the past seven years.

Important Lessons Learned From Relations With China

Over the past 16 years, we learned some important lessons about doing business in China.

1. When the Chinese government makes a promise, it will live up to that promise.

2. The most effective way to proceed in China is to build trust at the personal level by engaging in mutually rewarding activities. Finding ways to do things together, we slowly but surely moved into a number of mutually beneficial projects:

—The Chinese agreed to permit more of our films to enter the Chinese market and we agreed to do film festivals to introduce Chinese films to American audiences.

—Both sides agreed to work together to improve the efficiency and profitability of film distribution in China.

—Both sides found value in co-producing films in which Chinese stories are brought to life by our modern film technology.

—Both sides agreed to work together to open and modernize the home video and television industries in China.

—China agreed to take more of our film videos and more of our television programming. In turn, our studios agreed to bring in some Chinese television shows for U.S. audiences.

It is a step-by-step process in which both sides identify objectives and work together to achieve them. What is being accomplished is especially striking given the unique nature of the film industry. Our entertainment deals routinely with ideas and values that can be culturally and politically sensitive. For two countries with such different political and cultural histories, it is remarkable how far and fast our cooperation has developed. Now that China has entered WTO, we can expect the pace of cooperation to pick up even further.

Last year, 14 of our films were imported into China on a revenue-sharing basis. This is the way we do our business in the U.S. and around the world. This system of sharing box office proceeds is new to China. Under the terms of China's WTO entry, the number of foreign revenue sharing films entering China in 2002 will rise to 20.

The Chinese are not taking our films just to make us happy. They believe our pictures can play an important part in revitalizing the Chinese film industry. The Chinese want us to help them build more and better cinemas, a goal that is clearly in our mutual interest. They want us to bring them new technologies to make better films. We are doing these things, and the Chinese are providing us ever increasing access to their market, whether it be film, home video or television.

Impact of WTO Accession

China's new membership in the WTO will clearly help us progress in our business in China. However, the primary reason we are moving ahead is because our two industries have learned to work together in the daily task of running the business. We more and more think along the same lines. It is becoming a true partnership. Now our practical working relationship will be backed by the transparency and legal certainties of the WTO. This is a plus for both sides.

We have found no instances in which the Chinese have failed to deliver what they have promised.

Let me make an important point here. The strong cooperation developing between the Chinese and American film industries comes against a backdrop of massive economic and social change in China. It is a nation and society moving forward at breakneck speed. The rapidly growing appetite for our films is clear evidence of that.

Let me go through quickly a short report card on Chinese performance on the issues of particular importance to us.

Copyright Protection

The Chinese have moved decisively and strongly to honor its obligations in the 1994–95 IPR agreements negotiated with the U.S. They closed down illegal factories and are pressing on with the fight against pirates at the retail level. That continues to be a huge and difficult battle. We work side by side with our Chinese friends on this, providing training and technical help. Now, under the terms of the WTO

Agreement on Trade Related Intellectual Property (TRIPS), China is further committed to the fight against piracy. In that regard, on October 27, 2001, China adopted an amendment to its Copyright Law.

Market Access

The November 15, l999 agreement between the U.S. and China on China's accession to the WTO contained assurances that:

—There will be 20 annual revenue-sharing imported films.
—U.S. investors can invest in joint ventures for the distribution of videos.
—U.S. investors can own up to 49% in companies that build, own and operate cinemas.
—Tariffs on films will be reduced from the current level of 9% to 5%.
—Tariffs on home videos will drop from 15% to 10%.
—China will protect intellectual property under the terms of the WTO Agreement on Trade Related Intellectual Property (TRIPS).

There is no doubt in my mind that China will abide by these commitments. China showed the value of its word in working to implement the terms of the 1995 and 1996 agreements on intellectual property. The fight against piracy continues to this day because of the enormity of the problem. What has been achieved so far, however, has been impressive and is the result of unremitting efforts at the working level and strong and unwavering instruction from top Chinese leaders. We are not there yet, and the Chinese would be the first to acknowledge that. But the course is set and outcome is not in doubt.

I would expect a similar process as China moves to fulfill its WTO obligations. China's entry into WTO is only part of a broad and deep transformation underway across China. Many of the concessions that China made as part of its WTO entry were consistent with China's own goals to advance domestic reform goals. Certainly, that has been true for our industry. China's commitments in our sector under the WTO accession agreement were, in large part, things that the Chinese film industry decided it needed to do to revitalize its own business. That bodes well for prospects of compliance. Countries are most likely to honor commitments that they truly believe are in their own interest, rather than those foisted upon them by outsiders.

The reform process across China will not be without problems. The changes are wrenching and painful, but top leaders have been articulate in describing how these changes will benefit China and its people. It is our good fortune in the film industry to have reached a level of mutual respect and communication with our Chinese partners that we can now speak with total candor about how to expand our cooperation to the benefit of both industries. The WTO framework with its clear predictability in legal and trade terms adds immeasurably to the success of this process.

Thank you for this opportunity to appear before you today.

Chairman D'AMATO. Thank you very much, Ms. Richardson.

We'll move right on Mr. Smith. Go ahead, please.

STATEMENT OF ERIC H. SMITH, PRESIDENT, INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE

Mr. SMITH. Thank you, Mr. Chairman.

I am President of the IIPA. We represent not only the Motion Picture Association but also an organization called the AFMA, representing independent motion picture producers—I think that Mr. Spiegel's company is not a member of AFMA—but we also represent the business software industry, and BSA was mentioned, the Interactive Digital Software Association, the video game industry, the book publishing industry, and the record industry.

So we take a view across all of these industries, and I think Ms. Richardson was exactly right in that China has come a long way from the kinds of things I know that I was saying back in 1992 and 1993.

IIPA and all of our members were involved in 1992 with the MOU that first got China to pass a decent copyright law and in adopting regulations in which they did that. In 1995 and 1996 we dealt with the enforcement problem, the export problem. Exports totally disrupted the world market in optical/media products because of the many, many plants in China that were wholesale exporting all over the world.

Through the efforts of the U.S. Government, as you know, that problem has basically stopped. There is some leakage—as Bonnie said, there are some underground plants that are producing—but the Chinese Government is working to shut them down. In fact, they have shut down over 125—actually, over 130 now—optical/media plants that have been engaged in the production of pirate products. And the problem is now, really, for China an import problem, and all the plants that couldn't set up in China moved first to Hong Kong, then down to Malaysia, over to Macau, and they are now moving into Indonesia and, of course, in Taiwan. It is a huge problem, and China is working very hard to try to deal with it because it is an embarrassment for them to have all this product flooding into their market.

The bottom line is the domestic piracy problem has not improved significantly, but that means that that problem is limited to China, not disrupting the entire world as it was before.

To give you an example of the kinds of actions that the Chinese Government is taking as part of their WTO accession and because there has really been a remarkable shift in attitude in China since we all got started working on this problem. In 1995 and 1996, the Chinese were simply denying that this was a problem; they are no longer doing that. You can get minister after minister now to talk about the domestic piracy problem.

And I would say that at the highest level, there is a political will to deal with this problem, but there are endemic, systemic problems in China that prevent it from conquering this problem in a manner that we would like to see them do it, frankly, and we think there are some actions that they could take, and we have proposed these actions over the years that they could take to fix this problem.

I think the first problem is that their enforcement mechanisms tend to be sporadic and not very transparent, and it is much more difficult for foreign intellectual property owners to work with the Chinese Government as we work with other governments in the region, and that is partly historical, in the nature of kind of a closed China. That is changing slowly, and it is not going to change overnight—but it must change.

Secondly, there is very little deterrence in the Chinese system. They run a massive number of raids. Last year, they seized 51 million video CDs and 4 million DVDs. So they are doing a lot with this problem. They are trying. But what is missing in the system in China—and this is the thing that the Chinese must grapple with if they are going to deal with the piracy problem—is that there simply isn't any deterrence in the system. Their administrative fine machinery just doesn't work very well; the fines tend to be minimal, and as a result, people feel little threat to go into the business.

The production problem is kept in tune by simply closing the factory, and many of those people have gone to jail. But the use of the criminal law, which is used in every country in the world to deal with piracy, is almost never used in China. They have to deal with that problem. They have to increase their administrative fines, and they have to put more emphasis on coordinated, consistent enforcement and continually putting out the message to their own people, as well as what Ms. Richardson said, continue training, which the U.S. Government is doing and which our industries are doing in China, and that is very important as well.

Will it change overnight? I don't think so. Can the Chinese do a better job? Yes, they can. Do they want to do a better job? Yes, I think they do. Are they now in compliance with their WTO/TRIPS obligations in the area of enforcement with an over 90 percent piracy rate across each of the lines of business in the copyright area? The answer must be no, they are not in compliance with their TRIPS obligations, and they must take the actions that I mentioned in order to come into compliance.

Other countries have been able to make very significant progress, but they are smaller countries. China is huge, and it is not as centrally controlled—we know this. It is very difficult for the central government to make progress. But in time, and with cooperation with industry, local and foreign, they can deal with this problem.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF ERIC H. SMITH

Members of the Commission, my name is Eric H. Smith, and I am President of the International Intellectual Property Alliance, IIPA. I am pleased to have this opportunity to share with you the perspectives of the U.S. creative industries on copyright protection in China, and China's WTO compliance.

About IIPA

IIPA is a coalition of six trade associations [1] representing the major U.S. copyright industries, from books, recordings and music, to films, videos and TV programming, to computer software for business and entertainment uses. Since 1984, this diverse range of industries has been working together, individually and under the IIPA umbrella, to strengthen the copyright laws and enforcement regimes in over 100 countries around the world. IIPA and its members have also represented the copyright-based private sector in the negotiation of key bilateral and multilateral agreements to raise international minimum standards of copyright protection and, of increasing importance, enforcement.

Specifically, IIPA and its members were at the forefront of discussions in 1992 that led to the signing of a Memorandum of Understanding between the United States and China. That MOU obliged China to protect copyright in line with international standards. IIPA was also at the forefront of USTR-led negotiations again in 1995 and 1996, resulting in exchanges of letters, by which China undertook to close down factories *producing and exporting pirate CDs* with impunity (causing catastrophic disruption of global markets), and commenced the setting up of a nationally-coordinated enforcement regime for copyright protection. IIPA had both a stake and a role in the agreement between the United States and China on China's accession to the World Trade Organization, and IIPA and its members supported the granting of permanent normal trade relations in 2000. Finally, IIPA observed developments with great interest that led to China's entry to the WTO on December 11, 2001. Each of these milestones has had significant commercial ramifications for the U.S. copyright industries. We thank the Commission for giving us the opportunity to examine where China stands upon its entry to the WTO with respect to copyright protection, both in terms of its legislative and regulatory regime, and in the context of anti-piracy enforcement.

The conclusion is that while there are many hopeful signs of improvement in copyright protection in China, there is, particularly in the area of effective enforcement, much more to be done.

[1] IIPA's members are: the Association of American Publishers (AAP), AFMA (formerly the American Film Marketing Association), the Business Software Alliance (BSA), the Interactive Digital Software Association (IDSA), the Motion Picture Association of America (MPAA), and the Recording Industry Association of America (RIAA). IIPA's members represent over 1,100 U.S. companies.

WTO/TRIPS Compliance: Substantive Standards

First, the Copyright Law (following amendments made in late 2001) and certain regulations now ensure that U.S. right holders enjoy protection on the books that is TRIPS-compliant in most respects. Indeed, the latest round of amendments demonstrated the forward-looking nature of legislators in China, as they attempted to implement TRIPS obligations as well as many aspects of the new "Internet" treaties of the World Intellectual Property Organization.

Nonetheless, there are certain key areas China must look at now to strengthen its legislative framework including through adopting clarifying regulations directed at the new amendments. While time does not permit an extensive discussion, one of the more important areas the Chinese need to look at is strengthening criminal remedies against copyright infringement. Article 41 and 61 of TRIPS requires countries to provide "effective action" against "piracy on a commercial scale" which action must actually be a "deterrent" to further infringements. The Chinese law has provided for criminal remedies in certain cases of piracy since 1994, but the high threshold amounts that must be attained before prosecutors will prosecute piracy cases under that law has meant that these remedies have been used only rarely over the years, in contrast with other neighboring countries where criminal remedies are the rule. The Chinese government opts for using administrative fines but with a low penalty structure and system which brings too little deterrence to the enforcement infrastructure.

TRIPS Compliance: Enforcement Standards

Now turning to enforcement: Enforcement of copyright protection in China remains a major problem. Nevertheless this situation must be put into perspective. Seven years ago, China was flooding the world with pirate exports of CDs of all kinds, and domestically, China was often called a "one copy" market, in that only one legal copy of any product could be sold into China, as the Chinese would illegally copy the rest. We're glad to say, however, that times have changed. In 1996 and 1997, in large part due to the pressure brought to bear by the United States government and our industries, the Chinese undertook an aggressive campaign against the illegal CD plants, and aggressively implemented licensing requirements for old and new plants. This type of CD plant regulation has now been put into place in many countries in Asia and elsewhere. The results were impressive, with dozens of CD pressing lines seized and dozens of illegal plants closed down. Pirate CD plant operators apparently got the message that their illegal businesses were no longer welcomed on the mainland, so they, unfortunately, migrated elsewhere in Asia. We have been chasing them ever since.

In 2001 and in earlier years as well, in addition to routine enforcement actions carried out all over China against pirate retailers of audio-visual works, sound recordings, software and the like, the Chinese government launched specific "crack-down" campaigns against pirates at the wholesale and retail level and have issued decrees to legalize government use of business software and government sponsored piracy of books and academic journals. The government of Shanghai, for example, in 2000 ordered all 150 state-run stores dealing in copyrighted materials to sell only legitimate product. However, these campaigns tended to be reactive and sporadic, rather than regularized and sustained. Moreover, the type of deterrence necessary to permanently reduce piracy levels was simply not present in the system. For the business software industry, where unauthorized copying within companies and government entities cause the greatest losses, the criminal and administrative systems have just not been effective in curbing this problem.

Let's be clear: China did a great job in virtually eliminating export piracy, but, despite good rhetoric and many raiding actions, is still making only minor dents in the overall problem that affects its domestic market. To this day, piracy levels in China, namely, the percentages of products appearing on the domestic market in China that are illegal, remain very high for all sectors of the copyright industries, close to or over 90%. And the Chinese government has had to remain vigilant to track down pirate producers, lest they lose control of the problem altogether. For example, the Chinese government reports that 127 underground CD production lines were seized by it between 1994 and the end of May 2001.[2] One of IIPA's members reports that, in 2001 alone, central and local enforcement authorities seized over 51 million pirated VCDs and over 4 million pirated DVDs of film material alone. This is likely merely a fraction of the pirated product trading in China, showing the colossal magnitude of the problem.

[2] Report of the Office of National Anti-Piracy and Pornography Working Committee, the People's Republic of China, June 2001.

We all continue to hear stories of first run films like *Harry Potter* and *Lord of the Rings* appearing on the streets of China days after the film's release in the United States (and well before the film's release elsewhere). The same is true of popular music and software titles. However, the fact is that in China today, such pirated VCDs and DVDs could as easily have come from Malaysia or Taiwan as they might have from an illegal plant in China. Indeed, one of China's biggest problems today is stopping pirate imports through effective Customs enforcement.

However, it must be said that the Chinese government appears serious about reducing piracy and that government ministers are sincerely concerned about the problem. Indeed, these government officials readily admit that there is still a serious piracy problem in China, and both the problem and the government's awareness of it are widely reported in the Chinese press.[3] This is a remarkable change from the situation in 1995, when Beijing was in effect denying the existence of the problem, and the U.S. government was on the verge of imposing trade sanctions on China for failure to enforce its law against massive piracy. In attitudinal terms at least, the shift has been 180 degrees.

What is clear is that the Chinese government must continue to take strong action to turn the tide against domestic Chinese piracy. Positive signs abound, such as the shift from overt piracy to the present underground nature of the retail piracy business in cities like Beijing.[4] However, in other parts of China—in the South for example—pirate product is still blatantly on display. Aggressive enforcement must continue, and whether under the National Anti-Piracy and Pornography Working Committee, or a revitalized effort at the State Council level, the enforcement infrastructure must be better coordinated, and be more transparent to ensure that local and provincial enforcement agencies in China—including, most importantly, the Public Security Bureaus (PSBs) and national prosecutors—are effectively carrying out the campaigns announced at the national level, and put into place enforcement mechanisms that lead to sustained and deterrent results, including the use of criminal procedures against commercial pirates. As noted, the thresholds for bringing criminal actions must be lowered, and administrative fines must be raised, to make such actions truly effective and sustainable.

In addition, more must be done to keep piracy out of China at the borders. Also, the government must continue to convey to the Chinese people that piracy is wrong—that it hurts China first and foremost. Local copyright owners must be encouraged to contribute to the message that Chinese creators are being terribly damaged by these high piracy levels. And, as noted by my colleague from MPAA with respect to audiovisual product, China must continue market-opening measures that will only further encourage Chinese people to buy legal products.[5]

Conclusion: Still a Long Way to Go, But Getting There

Surprising statistics are starting to pour out of China, such as this one: China's software industry expected sales in 2000 to hit 20 billion Chinese yuan (or US$2.42 billion dollars) despite the fact the industry is only one-fifth the size of China's computer hardware sector.[6] Another one: China has more than 10,000 software companies as of mid-2000, among which 3,000 focus on software research and development.[7] Facts like these and the counterpart increasing internal development of the entertainment industry sector indicate a turn in the tide in China, for now that China's leaders recognize the possibility that Chinese creators will contribute positively to the economy, the drive to legalize copyright uses in China will do far more than simply placate foreign trading partners. Of course, there is the WTO, and from what we have seen, China is keenly aware of its obligations, and what it will take to meet them. Have they done this yet entirely? The answer must be no; they are not yet in compliance with their TRIPS obligations. But the wheels are turning, and we look to the future with great hope.

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[3] E.g., Copyright law solid but needs fortifying, China Daily, Sept. 14, 2000 (quoting then National Copyright Administration Commissioner Yu Youxian as saying that the Copyright Law in China needed amending because "[a]nti-piracy regulations are not strong enough, since piracy was not serious when the law first took effect," and that "more provisions must be added because piracy has become rampant [in China] today").

[4] Whereas once pirate product was openly sold on the streets, now peddlers are relegated to enticing customers to back alley ways by calling out "VCD" or "DVD."

[5] China's WTO market access commitments in the audio and audiovisual area continue to make it difficult to fully serve the Chinese market with legal product and thus contribute to the difficulties in lowering piracy rates. We hope that the Chinese government re-evaluates these commitments as its other WTO commitments kick in over the next three years.

[6] Software sees solid growth in sales, China Daily (citing a report of the China Software Industry Association (CSIA)).

[7] Id.

Thank you.

Chairman D'AMATO. Thank you very much.
Mr. Quam?

STATEMENT OF DAVID C. QUAM, GENERAL COUNSEL, INTERNATIONAL ANTI-COUNTERFEITING COALITION (IACC)

Mr. QUAM. Thank you, Mr. Chairman.

My name is David Quam, and I am the General Counsel for the International Anti-Counterfeiting Coalition.

I'm going to take a slightly different slant. You have heard a lot about copyright and entertainment industries. The IACC does have entertainment industries within its membership; however, we are much more extensive in that we cover industries including apparel, automotive, electrical equipment, entertainment, software, luxury goods, consumer goods, personal care and pharmaceutical sectors—just about any product you can think of is a member of the IACC. And because we have copyright experts at this table, and they have very well covered the world of copyright, I am going to focus more of my discussion on enforcement and trademarks.

The one unique thing about enforcement is with enforcement of all IP across the board, you can raise all ships. I will be the first to admit that the copyright industries did much better back in the early and mid-nineties, working with the U.S. Government in convincing the People's Republic of China to do something about copyright piracy in solving the export problem, in shutting down CD plants—you heard a lot of success stories. Ms. Richardson was very correct in stating that relatively speaking, the copyright industries are in a much better place.

On the trademark side, that is not really true. The problem still persists. There is a massive export problem that is made worse by the ability to distribute products worldwide even more easily today.

We had a recent example, a battery example, from one of our major companies who said that an entire container-load of batteries came out of China where the top layer was genuine product, but underneath that, everything was counterfeit merchandise—the practice of "salting." This is a problem across all industries, whether you are talking about apparel, batteries, consumer goods, other products leaving the country and ending up coming through developing countries and ultimately into the United States, the European Union, Latin America.

They talked a little bit about the pollution of optical/media in the mid-nineties. Trademark industries are still suffering from that pollution as China remains the number one counterfeiter in the world.

That being said, we do have to commend China on what it has done recently with regard to changes in its trademark laws, trying to improve several of its enforcement mechanisms, giving some new authorities to its administrative offices that are still responsible for most of the enforcement efforts in China.

That being said, I will echo what Mr.Smith just said—enforcement is a real problem. The administrative remedies do not deter. A civil fine or a fine from an administrative agency is merely the cost of doing business to a counterfeiter. Unless there are real criminal penalties and actual jail time—we have found this in the

United States as well—that is the only real deterrent we have ever found to trademark counterfeiting. It has real results when it is imposed. There are not results; it is not part of the enforcement equation.

To give you an idea of the scope from our standpoint, it is commonly accepted—and I am speaking more from a trademark standpoint here—that in-country counterfeit rates are between 15 and 20 percent in China and that counterfeiting in China accounts for about 8 percent of that country's GDP.

From a U.S. perspective, China is consistently one of the top five and often the top source of counterfeit merchandise seized by Customs officials. Between October 1, 1999 and March 31, 2001, the U.S. Customs Service seized over 1,000 shipments from China containing pirate and counterfeit goods, having a value of over $29 million. China's own Development and Research Center has issued a report indicating that counterfeiting in China is a $16 billion industry—those are not our numbers, but theirs.

No product is immune to counterfeiting. This is a worldwide epidemic. I can still remember an NBC story that came out of China where they did a report on goods that could be found on the street, and the reporter was actually able to secure not just a CD and not just a t-shirt, but actually an entire Jeep Cherokee which was counterfeit—the entire car, end to end. That is a sophisticated operation.

The IACC's 2001 Special 301 submission identified other goods like auto parts and industrial lubricants, chewing gum, and razor blades as some of the new types of products that are counterfeited.

Proctor & Gamble, an IACC member, has stated that it loses around $150 million per year to counterfeiting in China. Notably, the products I mention are not luxury goods with high price tags, but well-known brands of soaps, batteries, razor blades, lotions, household cleaning products—the stuff that we all buy off store shelves every single day.

If you seriously consider the price point for those products and what it would take to get to $150 million in losses, you begin to understand the value and scope of the trademark counterfeiting problem coming out of China.

What is the cause of these problems? Of course, it is the transitioning economy; the closing of state-owned enterprises; the entry of foreign companies into the marketplace; the promotion and acceptance of brand names within the market; local opposition to closing illegal operations—and here, we are talking about coordination between the vast array of enforcement agencies that do not always cooperate with each others and often do not.

What China has done is improved their cooperation with U.S. industry and with trademark holders so we can get more seizures. The problem, as one IACC member put it, however, is that its newfound ability to get authorities to conduct raids has actually made enforcement that much more difficult. The reason for that is because the penalties for individuals are so low, and the reluctance to shut down plants—unlike CDs and optical/media, there is a real reluctance to shut down manufacturing plants—that when the raids come off, they actually embolden would-be counterfeiters because the consequences are minimal, and their profits are still great.

As of today, I can say that we hope the new laws will afford better protection, enforcement, and tougher penalties. However, hope for better protection at some indefinite time in the future means that trademark owners will continue to suffer.

Trademark owners are participating in training programs—I agree also with Ms. Richardson that training and education may be the best thing that the U.S. Government and trademark industries can do. We are willing to do that on a continual basis, participating in those programs, and we would like to see more.

We commend the Chinese Government for what it has done. However, anybody can write a good law. The rubber hits the road when it comes to enforcement, and intellectual property rights are only as good as your ability to enforce those rights.

I thank the Commission for its time and for inviting us to testify.

[The statement follows:]

PREPARED STATEMENT OF DAVID C. QUAM

I am David Quam, General Counsel of the International AntiCounterfeiting Coalition ("IACC"). On behalf of the IACC and its members, I would like to thank the Commission for the privilege and opportunity to testify on the issue of intellectual property protection in the People's Republic of China ("China"). This issue is of great importance to many IACC member companies.

The IACC is the largest organization dealing exclusively with issues involving intellectual property piracy and counterfeiting. The IACC has approximately 150 members, representing a cross-section of industries, including the apparel, automotive, electrical, entertainment, software, luxury goods, consumer goods, personal care and pharmaceutical sectors. The total annual revenues of IACC members exceed US$650 billion. The objective that brings such diverse industries together is their need to protect and enforce their intellectual property rights and their customers from those who would steal such property.

First, because my co-panelists represent the copyright industries and have years of experience working on copyright matters related to China, I will not dwell on the same issues. In view of the fact that many IACC member companies from the copyright community also belong to the organizations represented by Ms. Richardson and Mr. Smith, it is not necessary to repeat those issues, except to say that given the intellectual property ("IP") enforcement issues in China, there is significant overlap regarding the problems affecting the copyright and trademark communities.

Second, the IACC acknowledges and commends China for the progress it has made in its IP legal regime in recent years. China has significantly upgraded and improved its IP laws as it transitions to a market driven economy. In the past year alone, several IP laws have been amended as part of China's efforts resulting in its recent entry into the World Trade Organization ("WTO"). Many IACC member companies favored China's entry into the WTO.

Specifically, the trademark law has been amended and includes provisions that contain stronger enforcement provisions. In addition, the Supreme People's Court has issued new interpretations regarding the application of the law in criminal counterfeiting cases, although numerous issues remain to be clarified. China is also amending its customs regulations relating to IP protection at the border, which we believe is vital to stopping trade in counterfeit and pirate product.

Next, we recognize that China's transition to a market driven economy is not a simple task, but a task that affects millions of Chinese citizens and has an impact on fundamental aspects of its economy. Thus, providing effective protection and enforcement of IP to both its domestic and foreign enterprises are a daunting challenge.

In general, the counterfeit and pirate production in China has a detrimental impact on companies in the Chinese domestic market and in markets around the world. Highlighting this for a moment, the U.S. Customs Service has seized over 1,000 shipments from China containing pirate and counterfeit goods between October 1, 1999, and March 31, 2001, having a value of over $29 million. IACC member companies have reported seizures of infringing goods produced in China by police and customs officers from around the world.

Regarding trademark counterfeiting in China, the trademark community did not focus on the magnitude of the problem or recognize the scale of the problem as early as the copyright community's recognition of a massive piracy problem. This is perhaps most evident by looking to the 1995 U.S.-China bilateral IP agreement addressing IP enforcement. Only one page of that agreement explicitly addressed trademark protection and enforcement. Thus, reflecting the fact that the trademark community did not make the U.S. Government aware of the problem adequately enough to be addressed in the agreement.

However, since 1995, the problem of trademark counterfeiting has become worthy of significant media attention[1] as trademark owners see a market flooded with counterfeit products. China's own Development and Research Center has issued a report indicating that counterfeiting in China is a $16 billion industry. While the copyright community has generally focused on pirate production of sound recordings, motion pictures, software and interactive games, the trademark community confronts a market filled with counterfeit goods that are not limited to a few product lines, but affecting every conceivable product.

The IACC's 2001 Special 301 submission to the Office of the U.S. Trade Representative identified goods from auto parts and industrial lubricants to chewing gum and razor blades being counterfeited. Procter and Gamble has previously stated that it loses $150 million per year to counterfeiting in China. Regarding a company like Procter and Gamble and many other companies whose trademarks are counterfeited, these are not luxury products with high price tags, but well known brands of soaps, batteries, razor blades, lotions, household cleaning products and other everyday products that people use. If one seriously considers what is being counterfeited and the quantity, it is staggering. To reach a loss threshold into the hundreds of millions of dollars for these everyday products, the quantity has to be voluminous because the price differentials between counterfeit soaps or batteries are not as great as between counterfeit luxury goods and genuine products.

The growth in product counterfeiting in China is due to a multitude of factors. Some of these are:

—Transitioning economy;
—Closing of state owned enterprises;
—Local protectionism/profit-making by officials from illegal operations;
—Entry of foreign enterprises;
—Promotion of brands;
—Opposition to closing illegal operations;
—Opposition to confiscating machinery used to make counterfeit goods;
—Reluctance to criminal prosecution;
—Inadequate funding of enforcement agencies;
—Failure to imprison repeat offenders; and
—Lack of imposition of fines that are more than the cost of doing business.

This is far from an exhaustive list, but some of the reasons for the proliferation of counterfeit goods.

During the past year, the Chinese Government has announced special anti-counterfeiting enforcement initiatives. These types of initiatives are welcome. However, the problem continues to be the lack of penalties that demonstrate the seriousness of counterfeiting and the injury caused to trademark owners.

One IACC member has informed us that because of the ability to get authorities to conduct raids, these enforcement actions have made enforcement more difficult. Why? Because individuals are not adequately punished and machinery is not confiscated, the operations go underground so that raids are more difficult because the location of the illegal operation cannot be detected.

In another case involving the auto industry, the same illegal production facility has been raided three times during a two and a half year period. Unfortunately, despite the raids, the operation has not been shut down because individuals remain free to work and the equipment remains in use. Though fines were imposed, the level of fines was not sufficient to deter those involved from returning to this illegal production.

As of today, I can say that we hope that the new laws will afford better protection, enforcement and tougher penalties. However, hope for better protection at some indefinite time in the future means that trademark owners will continue to suffer from severe counterfeiting.

The trademark community, while suffering from severe counterfeiting, has been actively involved in a dialogue with the Chinese Government both regarding law

[1] See "China's Piracy Plague," BusinessWeek (June 5, 2000); "China—A Powerful Faux China's Drowning in Pool of Counterfeits," China Online (July 14, 2000); "Beijing's Phony War on Fakes," Fortune (October 30, 2000).

and training/education. Trademark owners have worked to make concrete recommendations about legal changes that would improve China's IP enforcement regime. It is also involved in providing training to enforcement officials in order to improve their knowledge of IP. Moreover, trademark owners have helped to fund trips to China by U.S. experts, e.g., judges, prosecutors, FBI agents, private industry representatives and others. Thus, trademark owners have not only suffered economic losses from counterfeiting, but expended funds to help educate and train Chinese officials.

The training and education efforts of Chinese enforcement officials by both the IP community and the U.S. Government have been substantial. In addition to the workshops and seminars by trademark owners, the U.S. Government has funded many IP enforcement-training programs dating back several years. As a result of the 1995 bilateral IP agreement, which included detailed IP enforcement obligations, the U.S. Government funded numerous IP enforcement-training programs.[2] There is no doubt that the U.S. Government and industry have made a substantial investment toward assisting China in understanding what the enforcement requirements are and how these enforcement obligations might be implemented.

Supplementing these efforts are the efforts of intergovernmental organizations. Chinese officials have often participated in IP enforcement seminars funded by intergovernmental organizations having U.S. Government and/or industry participation.[3]

Looking ahead, IP enforcement training for China's enforcement agencies will continue. In fact, the IACC, IIPA and other industry associations have been meeting with the U.S. Patent and Trademark Office about a planned program later this year. Moreover, other agencies of the U.S. Government and other associations are working on additional IP programs.

An indication of the importance of effective IP protection in China comes from other Governments as well. The U.S. IP industries are not alone in suffering from massive piracy and counterfeiting. Opportunities to impress upon the Chinese that more must be done to enforce IP rights may exist in concert with European and Japanese officials and their industries.

European IP officials have also recognized the IP issue in China and have established an office in China. This presents an opportunity to explore the possibility of joint U.S.-European actions that may prompt China to improve its IP enforcement. From an industry perspective, U.S. and European companies are already working together in China on the trademark counterfeiting issue. Therefore, to the extent that the U.S. and European governmental agencies can engage Chinese officials on matters of mutual interest, this should be encouraged.

Recently, the Japanese Patent Office has voiced its concern about China's counterfeiting of Japan's trademark industries. Indeed, given the fame of Japan's products, the U.S. Government and industry should encourage Japan's active involvement in the anti-counterfeiting effort. For our part, the IACC has met with Japanese officials on several occasions in recent months to explain the importance of Japan's more active role in combating counterfeiting in China, whether through its companies that are the victims or through the Government's effort to engage the appropriate Chinese Government entities.

Conclusion

Despite the progress in legal amendments in China, it is difficult to be very optimistic about enforcement in China. The enforcement system is complex because of the numerous administrative agencies as well as the tensions between the various levels of entities, e.g., national, provincial, local/municipal. In addition, because fines help to finance the operations of the entity that collects the fine, there is no motivation to coordinate enforcement efforts, a fundamental obstacle to effective enforcement.

Moreover, despite the progress in IP laws and special anti-counterfeiting initiatives of limited duration, trademark owners continue to suffer severe counterfeiting. It raises the question: what can the U.S. Government do on behalf of the affected industries if counterfeiting remains at these levels? This may be an issue worthy of further study and one that requires increased industry-government dialogue.

On behalf of the IACC, I thank the Commission for this opportunity and am happy to answer any questions you may have.

[2] Although China has just entered the World Trade Organization, TRIPS-related training was being provided in 1995 to prepare China for its need to provide TRIPS compliant enforcement.

[3] The IACC has participated in a number of IP enforcement seminars funded by the World Intellectual Property Organization that have included Chinese participants.

PANEL IV DISCUSSION AND QUESTIONS AND ANSWERS

Chairman D'AMATO. Thank you very much, Mr. Quam, and I thank the panel for their testimony.

I am glad we had this panel, because there seems to be a little difference of opinion on the importance of what has been going on in China. Let me ask a couple of questions.

Is there any disagreement among the panel that the piracy rate of films is still in the 90 percent range and is not dropping significantly at all? Does anybody disagree with that?

Mr. SMITH. As I think Ms. Richardson said, the piracy rate has dropped slightly in motion picture area, maybe one or 2 percent, last year.

Chairman D'AMATO. So it is still in the 90 percentile range. So basically, they pirate everything.

It is very good that China did a great job of virtually eliminating export piracy, which I think is not of much consequence to our industry or to me, but the problem is that internally, it looks like, as you said, Mr. Smith, despite good rhetoric and many raiding actions—and maybe it is 50 million or 50 billion CDs—it is still in the 90th percentile—they are still making only minor dents in the overall problem that affects its domestic market. So there is no change in the domestic market.

What I am hearing from Ms. Richardson is that the Chinese Government can't do much about that. The Chinese Government can do a lot about things it cares about. If it cares about Falun Gong, it can eliminate 20 million adherents in 2 years. That's pretty impressive human carnage. But it can't do anything about a 90 percent piracy rate.

My sense is that Mr. Smith is right that there are no penalties in this market for this behavior, and until there are some penalties, or until the Chinese Government gets serious about it, this situation is not going to change.

The other thing I hear is that it is very good that the Chinese have agreed to allow 20 films into their market. I believe that is not 20 American films, that is 20 foreign films—up from 10—but that number does not increase over the life of the WTO; it stays static. What I see is a closed Chinese market to American films—closed—and a continued piracy rate.

So how we can be optimistic and excuse the Chinese Government's behavior in this regard is just beyond me—it is beyond me. It is a whitewash.

So I appreciate Mr. Spiegel's testimony because it is courageous, and it is right on the money. That's what I have to say.

Commissioner Wessel?

Commissioner WESSEL. I also agree with Mr. Spiegel, and I want to commend you for the passion that you bring to this. As one who probably stands the most to lose when your property is ripped off from you all the time, I understand your anger and displeasure.

I also understand, having worked with a number of the other participants at the table over time, the creative tension that exists, that you must pressure a case forward and at some point accept the result.

My problem with that is that we have accepted the results, we have sung the praises of the Chinese year after year, and in the end, we find that we are getting ripped off. We saw the first MOU on Intellectual Property signed. We heralded its signature, and we talked about a new day. Three or four years later, we were back, proclaiming that it was a failure and we needed to do a new one. Rather than seeking to truly enforce the agreement they had signed, we went back to the table and said let's get a new agreement.

Now we have the WTO agreement, which I question whether the Chinese are truly going to enforce. There are many who are reluctant to go through the WTO process and take the potential for retribution by the Chinese by raising problems and what that may mean. So I don't see the 90 percent rate coming down dramatically unless, as Mr. Smith said, they start getting serious about enforcement.

So let me ask a question on that. Is there anything you see on the horizon—that the Chinese will impose criminal penalties, any of the other actions that you talked about that would be necessary to see true enforcement—are any of those being proposed in the Chinese legislature or from the leadership?

Mr. SMITH. Unfortunately not. It is something that we have been pressing for for a long time, and at least we have heard of no move to increase criminal penalties. There is a team going over from the United States very shortly—in fact, they left today—and one of their principal missions will be to press both the issue of increasing administrative fines—which the Chinese have made noises about doing, and I think they know that this is a problem—but on the criminal side, we haven't seen a lot of movement. It is something that is really critical, and the mission led by USTR is going to be pressing that case pretty hard.

Commissioner WESSEL. But they are under no obligation to use any of the enforcement tools you have just talked about.

Mr. SMITH. Oh, they absolutely are.

Commissioner WESSEL. They are?

Mr. SMITH. The TRIPS enforcement text in Articles 41 and 61 requires, as I noted in my testimony, effective action that deters infringement, and they must have criminal penalties, and they must use them.

Commissioner WESSEL. So they are required to change their law to impose criminal penalties?

Mr. SMITH. Well, they have—piracy is a crime in China—they just don't prosecute it—and they have a system of thresholds that they have established, so before they will prosecute a crime in China for piracy, you have to show income to the pirate of $6,000, and that is income to the pirate, not losses to us. So it is a crazy system, and we are suggesting changes in that, and the U.S. Government will be present for changes in that, and until that is done, it is going to be very difficult for the Chinese to bring any real deterrence into the system.

I should say, however——

Commissioner WESSEL. Let me also understand that—we could say that they are not complying with their WTO commitments unless they make those changes; is that correct—because you are having your rights nullified and impaired; you are not able to have effective enforcement as they are required to do.

Mr. SMITH. I think under any test that you bring to those two Articles of the TRIPS Agreement, China is not there yet. They have more to do.

Commissioner WESSEL. Am I correct—and the numbers may be wrong—that copyright-based industries are our second largest export? Is that right—internationally.

Mr. SMITH. We are actually the first major sector; well over $80 billion in exports in foreign sales in the last year. We measured it, and we have a new study coming out shortly. We have surpassed agriculture and aircraft and automobiles now. So most of our companies generate half of their revenue outside the United States and are growing domestically twice as fast as the economy as a whole.

Commissioner WESSEL. So for our national wealth, despite my believing in your artistic creativity, this is real dollars to our economy.

Mr. SMITH. Absolutely. It is 4 percent of U.S. employment, 5 percent of U.S. GDP, and employment is growing at three times the rate of the economy as a whole. So in terms of employing workers, nurturing these industries is critical.

Now, China is not the only problem. China is not yet a huge factor in this because that market, for the reasons that have been mentioned here, remains pretty closed. But we see signs of opening—the WTO commitments—book publishing 3 years from now will be a completely open market. The audiovisual sector because of its political sensitivity is not as open, and we wish it were, but the reality is that that is the way it is. And I think Bonnie would say—and I'm going to ask her, or you'll turn to her in minute—I think there is going to be a consistent progression to open that market despite the WTO provisions that say 20. I think it will go above that, kind of as a commercial matter, and I think Bonnie would agree with me on that.

Ms. RICHARDSON. I would like to clarify that if I may, Mr. Chairman.

Chairman D'AMATO. Go ahead.

Ms. RICHARDSON. There is a misunderstanding about what "the 20 films" means. It is not an overall quota of foreign films or limit on American films' entry into China. It has to do with one specific kind of deal that we, the major studios find very important—revenue-sharing.

The way we operate in worldwide markets is instead of selling our film for a set price, we agree to split the box office revenues. If the film does well in theaters, we get a lot of money; if the film does poorly in theaters, we get approximately half of a much smaller amount.

The 20 films per year limit only applies to that kind of revenue-sharing deal. There is no quota on the kind of film deals that Mr. Spiegel, I think, normally does, which are flat fee sales.

It is also important to recognize that the WTO commitment does not contain built-in growth. Two answers there—we fully expect that film access will grow without a WTO commitment. We are hearing Chinese officials today talking about their expectations the 20 film limit this year they will grow without a WTO commitment.

We think that in the next couple of years, we'll have 40 or 50 films a year in the Chinese market. Given the infrastructure requirements, the fact that they have too few cinemas, the fact that the distribution networks aren't yet fully developed, that's probably all that we can jointly handle. Beyond that, China has no quotas on home video products now. This is a new development that came out of the newly released video regulations. They want hundreds and thousands of new titles for home video entertainment. And in fact, that's the kind of piracy we're talking about. We're not seeing theatrical piracy in China; we are seeing home video piracy. The home video market is developing and growing. The legitimate outlets are growing and I think will grow fast, now that these new regulations are in place, so it will be much easier to bring in legitimate products to come in behind and replace the pirated product.

Chairman D'AMATO. Thank you. It all sounds like a lot of hope to me. I don't see any delivery. I don't see any delivery. I see hope—I see the number 20.

Ms. RICHARDSON. Well, we were at four films 5 years ago.

Chairman D'AMATO. Twenty. Twenty is nothing. That's a closed market. Twenty films? I've got 20 films in Annapolis every week.

Ms. RICHARDSON. We, the studios, only make approximately 150 films a year. It is not an insignificant portion, and if they are 20 blockbusters, it's significant.

Chairman D'AMATO. But the 20 is not just American films, is it?

Ms. RICHARDSON. Under the international national law, it is not. Practically speaking, we are the most competitive film industry in the world, and we are completely confident that we will supply the majority. The majority of the foreign film imports into China have always been American, and as long as we keep making good films, they will always be American.

Chairman D'AMATO. Oh, I agree with you there. I mean, I don't watch any of those foreign movies.

[Laughter.]

Commissioner Bryen?

Co-Chairman MULLOY. Please let me ask a followup while I'm still here, and I won't ask any other questions.

On that whole question, the 20 was part of the bilateral with us; is that correct?

Ms. RICHARDSON. It was negotiated as part of the WTO bilateral negotiations between the U.S. and China, yes.

Co-Chairman MULLOY. Under MFN—right; they share in it.

Ms. RICHARDSON. That's right.

Co-Chairman MULLOY. But none of these other countries made this type of issue a priority in their own negotiations with the Chinese?

Ms. RICHARDSON. You are absolutely right. Moreover, the EU tried to come in behind the U.S. and undo some of our audiovisual commitments with China.

Co-Chairman MULLOY. Is that true on most IPR issues, that the other countries are not as concerned about these issues as we are?

Mr. SMITH. In general, yes. At the international level, the United States has been the principal actor in improving intellectual property protection around the world. The Europeans, we have tried to get to join us and partner up with us, but they have had other interests.

Co-Chairman MULLOY. So in making this a priority in terms of—we are not going to have a lot of allies.

Mr. SMITH. Well, I think there are a lot of countries that support us, but they are not supporting us in the kind of active way that we would like to see.

I think the whole attitude toward intellectual property protection in the last 10 years has turned 180 degrees. I think even in developing countries, there is no longer the kind of argumentation that, well, it hurts our balance of payments if we deal with piracy. People, ministers, intellectuals, do now believe that good intellectual property protection is good for economic development. I think that is changing globally.

Chairman D'AMATO. Commissioner Bryen?

Commissioner BRYEN. Thank you. It was very interesting testimony.

I have a question about the films that are being pirated. Are films being pirated that the Chinese Government would not like?

Ms. RICHARDSON. Yes.

Commissioner BRYEN. So it is subversive as well.

The reason I ask the question is that we could make this an interesting—one way to smoke out this problem is to send them lots of films they don't like and see how long they allow the piracy to continue. It may be a way to tweak and test the system.

The price of a film on the street in China—is it $1.20, something like that?

Mr. SPIEGEL. Some of them are as low as 80 cents.

Commissioner BRYEN. Eighty cents.

Mr. SPIEGEL. Some are as low as 80 cents, yes.

Commissioner BRYEN. And cost of production is 20 cents?

Mr. SPIEGEL. It is probably less; I would say probably less.

Mr. SMITH. A CD is about 25 cents to produce.

Commissioner WESSEL. You need to also update your figures—75 cents, since somebody just brought over about 50 two weeks ago that I saw.

Mr. SPIEGEL. Okay.

Commissioner BRYEN. The distribution network—is it above ground, is it visible, or is it sort of sub rosa? Can you just go and buy these things anywhere?

Mr. SPIEGEL. Yes. They are for sale on the streets in every city in China. And I would like to make one point that both Bonnie and Mr. Smith just discussed. Yes, there are some 20 millions pirated video discs destroyed. Yet, how come the piracy problem hasn't reduced below 90 percent? The reason is—well, there are a number of theories. One is that this destruction where they use a sports arena, bring in the press and destroy these videos is merely showboating. That's what I referred to in my opening statement. That is only one theory. But the bottom line is that it hasn't affected, except in perhaps the most negligible way, the amount of pirated motion pictures available in China.

Commissioner BRYEN. Let me ask a question. The price of 80 cents—has it gone up or has it gone down—it's a serious question, because it tells you whether or not enforcement has had any effect, because then you would think the price would start to go up, because of the costs involved to the producers, because when you raid one of these places, I assume you destroy their stock, you destroy the equipment—and even if you don't put them in jail, certainly there is a cost involved, so the more pressure that is put, the price should go up.

Has there been change in the price? Has it gone up or down?

Mr. SPIEGEL. Well, my last figure was 80 cents. Commissioner Wessel just said it was 75 cents. So obviously, it has gone down.

Commissioner BRYEN. And if it has gone down, then in fact it is showboating, and the results are not very good.

Mr. SPIEGEL. That's at least my contention.

Commissioner BRYEN. That would be interesting if you all could take a look at that as a kind of indicator as where we are at. The street price ought to tell us a lot about whether or not they are serious or any potential for serious enforcement, and if there is, if you look around by region and area, it may also tell you where the enforcement is and where it is not. That would help. I think that no one likes this—no one likes this at all—and we are trying to find ways to deal with it and to encourage the Chinese to deal with it, but we have to really know what the trends are.

You can say all day they have made progress, but they are still at 90 percent, the price is still very low, and it sounds to me like they are not really getting very far. So I would like to get as much data, and if you could provide to the Commission that data, it would be very helpful.

Thank you.

Chairman D'AMATO. Thank you, Commissioner.

Commissioner Becker?

Commissioner BECKER. My question was already asked and answered.

Chairman D'AMATO. Commissioner Lewis?

Commissioner LEWIS. I'm really very confused. I hear Mr. Spiegel giving a presentation about a major problem that is occurring. He seems to be in agreement with Mr. Smith and Mr. Quam. And then I hear you, Bonnie, disagreeing with them. I'm not sure what the disagreement is, because he said that "It is impossible to sell legitimate videocassettes in China. The IIPA reports unauthorized public performances of U.S. motion picture products continues unchecked in hotels, clubs, movie theaters, and government facilities."

Obviously, the government could stop that if they wanted to. Mr. Quam says that "One IACC member has informed us that 'because of the inability to get authorities to conduct raids,' enforcement is very difficult."

And Mr. Smith is saying, "The conclusion is that while there are many hopeful signs of improvement, copyright protection in China, particularly in the area of effective enforcement, there is much more to be done."

So I'm not sure why you are disagreeing with Mr. Spiegel. I don't understand that. When you say, "We have found no instances in which the Chinese have failed to deliver what they have promised." They could close down all the illegal use of videocassettes in hotels and clubs, but they aren't doing that.

Ms. RICHARDSON. It hasn't been our major focus——

Commissioner LEWIS. That's not the issue, though. Why are you disagreeing with him? It seems to me you should be saying, "Yes, I agree with you."

Ms. RICHARDSON. I said, "Yes, I agree with you that piracy levels in China are high, and yes, I agree with you that they have to come down."

What I disagreed with was virtually every conclusion he reached after that.

Commissioner LEWIS. Well, without saying that, give me the examples of where you disagree.

Ms. RICHARDSON. Well, for example, he said that the production of optical disc piracy is up in China. He is absolutely incorrect. The production of optical disc piracy in China has come down 90 percent——

Commissioner LEWIS. Domestic production?

Ms. RICHARDSON. Production of optical/media piracy, yes.

Commissioner LEWIS. Okay, that's number one. Go ahead.

Ms. RICHARDSON. The production of optical/media piracy is now a Southeast Asia problem.

Commissioner LEWIS. Okay.

Ms. RICHARDSON. He talked about piracy rates going up. In our industry, that's not true. And in three major markets where we stand to make money, these piracy levels are a bit theoretical. We have to look at where we could be making money, where we are operating.

Commissioner LEWIS. How about clubs and hotels?

Ms. RICHARDSON. It hasn't been the major focus for us. Maybe it should be. But we have been focusing more on optical disc piracy. We focused first on eliminating the export piracy—and Mr. Chairman, I must have been very unclear. Export piracy hurts us because it eats worldwide sales. It was our product that China was pirating and exporting in the nineties to Malaysia, to Singapore, to Hong Kong, so our sales in those markets were being hurt. That's why it is so important——

Commissioner LEWIS. Okay, optical discs.

What other conclusion do you disagree with him on?

Ms. RICHARDSON. That is the big one; that is our future. Optical disc is the format that we are looking at.

Commissioner LEWIS. You gave a universal condemnation—"I disagree with everything else"—and you have only named one.

Ms. RICHARDSON. In my rebuttal, I thought I named more. He said he therefore calls for harsh U.S. Government anti-piracy retaliation efforts. I think that that is exactly the wrong way to go. I believe we need to build the capacity in the enforcement networks in China so that they can do a better job. So I think his solution on where we should go from here is completely inadequate, and I think training and capacity-building is the better way to go.

Commissioner LEWIS. Thank you.

I'd like to give Mr. Spiegel a chance now to respond to what you just said.

Mr. SPIEGEL. Well, what Bonnie says is correct. However, I would add that if we are losing $2 billion a year——

Commissioner LEWIS. Excuse me. Do you disagree with that, Bonnie, that we are losing $2 billion a year?

Ms. RICHARDSON. Not just in films, but across all copyright industries, yes, I agree with that.

Commissioner LEWIS. Okay.

Mr. SPIEGEL. If we are losing $2 billion a year, year after year after year, by the time we train these Chinese and we set these enforcement networks in place, it will be 10 years from now, if ever.

What I believe the United States should do is say to China, "If you continue to do this, you are hitting us basically in our bread basket, and we have to reciprocate and hit you in your bread basket." To me, it is clear and simple.

With all due respect, there are a lot of diplomatic niceties that go around, and meanwhile, $2 billion a year is being lost to piracy.

Commissioner LEWIS. Thank you.

Mr. Smith, do you agree that there ought to be reciprocity?

Mr. SMITH. Well, I would put it slightly differently. The Chinese just joined the WTO. They have these obligations as of December 11. They are very, very aware that they have these obligations.

Commissioner LEWIS. So you're hopeful that something will be done.

Mr. SMITH. Yes. And I think at some point down the road if things don't change, we all have to look at different strategies and what we have been talking about here—but they have just joined it.

Commissioner LEWIS. Mr. Spiegel, this morning when the government people were here on the first panel, I did ask them what they were doing about piracy, and they assured us that this is going to be high on their agenda, so it will be interesting to see what happens.

Mr. SPIEGEL. Yes, it will be. And I hope they are able to.

Commissioner LEWIS. We asked for written responses.

Mr. SPIEGEL. Good.

Chairman D'AMATO. I have one informational question for Ms. Richardson.

Did you say that there was no limit on the number of, I think you called them flat fee licensing films.

Ms. RICHARDSON. That's correct.

Chairman D'AMATO. I have a release here from Mr. Jack Valenti dated April 11, 2000, that China will also, besides the 20 films, allow an additional 20 foreign films per year on a flat fee licensing basis.

Ms. RICHARDSON. That was my misinformation. At one step of the negotiation that formula was being contemplated—a cap on both the revenue-sharing films and on the flat fee-sharing films.

The second piece dropped off. There is now no quota in the Chinese schedule having to do with anything other than the revenue-sharing films.

Chairman D'AMATO. Thank you for that, and just one followup. Do you know how many flat fee licensing films have gone into China in the last—let's say last year—do you track how many have gone in?

Ms. RICHARDSON. We don't, because our member companies don't do that kind of deal, so we have no idea.

Chairman D'AMATO. How could we get that information?

Mr. SPIEGEL. I have no idea.

Chairman D'AMATO. That would be important information for us to get to find out whether this market truly is opening or is too politically sensitive to handle American films.

Commissioner LEWIS. Is there are association that does this flat fee licensing?

Mr. SMITH. Yes. AFMA, one of our members, represents about 170 independent producers who tend to sell their product outright into China. I can't say they keep accurate statistics from their membership of what goes into China, but we could certainly ask.

Chairman D'AMATO. I would like to get that information, if we could just ask them and see what we can get.

Commissioner Becker?

Commissioner BECKER. I thought my question a little while ago was answered, because I was wondering if there was any WTO obligation to enforce the TRIPS agreement, and apparently, there is.

We have had testimony here—and this is almost an observation—we have had testimony here earlier today that suggested that since China was in effect, I guess, a non-market economy and maybe still is considered a non-market economy except to the extent qualified by the WTO, that we had tremendous leverage in dealing with China prior to the WTO. In other words, we could do almost anything. There was no restriction in how we dealt with China. It could be unilateral, it could be heavy-handed, it could be trade sanctions—almost anything that we wanted to do.

The film industry, the entertainment industry generally across the board, supported—strongly supported—entrance into the WTO. Surely this was being weighed by the industry, then, that the leverage that was applied that brought about the TRIPS, the leverage that was applied at various stages over the last decade trying to deal with piracy, that you were foregoing this type of leverage against China and putting it into the WTO process.

That is almost just an observation. I go back to what Mr. Spiegel said—we should send a strong message to our government to do something. What specifically should the government do at this point?

Ms. RICHARDSON. I'd like to start on that one, and I'll start by pointing out that the U.S. Government's record in using WTO dispute settlement in the intellectual property area has been really excellent. They have aggressively brought cases since the beginning of 1995 when the agreement went into effect.

Commissioner BECKER. You mean with other countries.

Ms. RICHARDSON. Yes. So I have no doubt that if we help them prepare a case and ask them to take the case to enforce our rights in China that they will do so.

Commissioner BECKER. This was through the WTO process?

Ms. RICHARDSON. Through the WTO dispute settlement process. It has been of tremendous value to us. It forced Ireland, for example, to put a modern copyright law into place. It helped us bring pressure and end a 10-year-old problem with Greece where they were pirating our television product throughout the country without regard, and nothing we did under the criminal law system in Greece worked.

Commissioner BECKER. So you feel that the entrance into the WTO is the leverage that the entertainment industry needs in order to resolve this?

Ms. RICHARDSON. I believe that it has been very effective to date, and I believe it will continue to be effective.

Commissioner BECKER. Were those cases through filing in effect what I refer to in my industry as "trade cases"—just straight-out piracy under trade cases rather than under legal action.

Commissioner WESSEL. Not done with 201 or dumping category.

Commissioner BECKER. That's what I meant—201, anti-dumping, or any other provisions within our existing trade laws—or was it done through——

Mr. SMITH. In 1994–1995, when we were facing this massive export problem, it was a case brought under 301—Special 301. The IP portion of Section 301, we threatened $4 billion of retaliation——

Commissioner BECKER. Now, this was in what country?

Mr. SMITH. This is China—pre-WTO. But I just want to say that yes, with countries that are not members of the WTO, we have the ability to undertake bilateral retaliation, some of which we forego—some of which, not all of which, we forego—when a country joins the WTO. But it is a careful balancing. I mean, yes, we lost some bilateral leverage, but we gained, hopefully, massive multilateral leverage through the WTO.

Commissioner BECKER. Is this what you are talking about, Mr. Spiegel, when you say we should send a strong message to the government to do something?

Mr. SPIEGEL. I am concerned about the bureaucracy of the WTO in this particular matter. I also wonder whether some of the other member nations really have our interests at heart here. I have a concern about the effectiveness of WTO sanctions in this particular area. If we can, it would be excellent, but until are able to, again, $2 billion a year is being lost to piracy, and I think we must do something in the interim to halt that as best we can.

Commissioner BECKER. But your colleague seemed to be leaning toward the WTO for solutions that were not available before their entrance or accession into the WTO.

Mr. SPIEGEL. Well, my question is only about enforcement—will the WTO actually enforce sanctions in this area that might really be effective. I'm not saying they won't, but I don't know whether they will or not. I'm sure Mr. Smith would know better than I.

Mr. SMITH. Well, it isn't a question of bureaucracy so much. I mean, there are dispute settlement panels with three people, and you make a case, and they decide whether or not the agreement is violated, and if it is violated, eventually, they can authorize the aggrieved party to retaliate, and it is multilaterally authorized.

But I think the point that Mr. Spiegel makes is in part correct, that the TRIPS enforcement text is not as specific as we would like it to be, and it is not going to be a slam-dunk to win in enforcement cases.

Commissioner BECKER. Why is he only in part correct? Why isn't he totally correct? You say he is in part correct.

Mr. SMITH. Well, because there are some things in the WTO enforcement text that are slam-dunk. I'm just saying it depends on the nature of the case you bring. And I am making a very broad statement. It depends on the cases you bring against China.

Ms. RICHARDSON. But again, it is helpful to look at what has been achieved instead of speculating about what might be achieved. I can tell you that we brought an enforcement case against Greece, and we never even had to go to the dispute panel. The Greeks said, "You are right"—or, they didn't actually say it, but their action changed. After 10 years they finally forced their television stations to stop pirating, because they knew that if we actually went to a WTO dispute settlement panel, they would lose. So the system works.

Commissioner BECKER. Very good. Thank you, Mr. Chairman.

Chairman D'AMATO. Thank you.

Vice Chairman Ledeen?

Vice Chairman LEDEEN. I am curious—since I am writing a book on Naples—how does it work, exactly? These movies that are pirated in China, are they just dubbed straight out, I mean, they are copied so they are in English?

Ms. RICHARDSON. No. The organized criminal elements in Malaysia, for example, that are running large pirated plants make a first-rate product these days. They will put multiple language tracks on it. They have even started advertising local products on our movies.

Vice Chairman LEDEEN. For Malaysia or for China?

Ms. RICHARDSON. We have seen both. We have seen regional distribution models by the pirates.

This is big business, and it is awful. All I am saying is it is a regional problem. The production is not happening for the most part in China.

Vice Chairman LEDEEN. And it's not just a matter of copying the things; that is, there is value-added, so to speak.

Ms. RICHARDSON. Unfortunately, more and more so these days. It's the whole range. Pirates will take some camcorded versions from theaters in New York when the movie opens, and they will release a pirated version 48 hours after the film opens in New York. It may be a poor quality version—it may have popcorn crackling in the background—but, later, they will bribe a cinema owner or a projectionist in, say, Malaysia or Singapore or wherever they can bribe someone, and they will steal or "borrow" a movie print for the night, take it back to their headquarters and run a perfect copy. Then they release a VCD or DVD version of our movie probably 6 months before we release that product in DVD format.

I am not saying the problem is not terrible. It is a terrible problem, but it is not a uniquely Chinese problem, and in fact, the locus is in Southeast Asia.

Vice Chairman LEDEEN. So these things are then distributed worldwide——

Ms. RICHARDSON. That's right.

Vice Chairman LEDEEN. —not just China.

Ms. RICHARDSON. Not just China.

Vice Chairman LEDEEN. And it is audio, it is video, it is all these products; right?

Ms. RICHARDSON. That is exactly right. There was a big Customs raid in Macau the last week of December that found a shipment headed to the United States of first-quality DVDs. The good news is they found it, and they stopped it. The bad news is that it happened.

Vice Chairman LEDEEN. Right. And is it fair to say that there is cooperation between various regional organized crime groups in this business as well?

Ms. RICHARDSON. Increasingly. It is another area where improvement is needed, but I think that increasingly, enforcement officials are increasingly recognizing the organized criminal element to this kind of piracy and are cooperating to try to get a handle on it.

Vice Chairman LEDEEN. Thank you.

Mr. SMITH. It's like the narcotics trade, really. It is so profitable. The cost of production is so low, the profits are so high, that particularly in Asia, it is just a hugely profitable enterprise. And I think we need to put China into context there, because the rest of Asia is exporting globally. China is not. So China is terrible—I don't deny that; I don't think anyone wants to deny it, and no one here has denied it—but piracy rates throughout the developing world hover between 60 and 90 percent, and none of these countries—and some are better than others—but none of these countries we believe probably is in compliance with their TRIPS enforcement obligations.

There is just a lot of work to be done, but it is not a snap your fingers kind of thing. We have to get at this in an organized way. You have to have deterrence, you have to have structure, you have to have training. You just can't waive $4 billion of retaliation and expect it to happen over night. It just doesn't work that way.

We have been in this business for a long time, and we try to work it slowly, so it is not going to be overnight.

Vice Chairman LEDEEN. Got it. “Only a sucker pays retail” is a universal truth.

[Laughter.]

Chairman D'AMATO. This is a rich record.

Commissioner REINSCH. Are you endorsing piracy?

Vice Chairman LEDEEN. I am not endorsing piracy.

Mr. SMITH. It will be pirated in China.

Vice Chairman LEDEEN. Look, I am an author. Are you kidding? Books are published and reprinted in China with no royalties, with no legal agreement, totally illegally and so forth, and every author on earth dreams, because every author knows that if I could just get one percent of all Chinese to buy my book, I will never have to attend another Commission meeting.

[Laughter.]

Mr. SMITH. Except they would only pay 30 cents a copy.

Vice Chairman LEDEEN. I know—but it's enough, it's enough.

Commissioner BECKER. That was the story of the textile manufacturers in England years and years ago—one T-shirt was all they wanted to sell to the Chinese.

Chairman D'AMATO. I want to thank the panelists.

We can all conclude a couple of things, it seems to me. Number one, China is terrible.

Co-Chairman MULLOY. On IPR.

Chairman D'AMATO. On IPR.

Secondly, I think it's fair to say that in this, as in almost all other areas that I can think of, it would be foolish to say that the industry itself can bring about the changes in another government's policies; that would be too much to expect.

So, thirdly, I conclude as I have concluded in the past when we took a look at what was going on between Canada and the United States, where you have essentially outright theft of an entire industry by our neighbor, and nothing has been done about it by the United States, that it falls squarely in the hands of the United States Government to get its hands around this issue and move it forward.

It is not overnight, but it isn't forever, either. It seems to us that more action needs to be taken, particularly in the enforcement area. We appreciate that, and we would like to have more ideas from the industry about how we can move the Chinese Government forward.

I appreciate the testimony. It was a great panel. Thank you very much.

We'll take a 5-minute break before our next panel.

Commissioner BECKER. May I ask one more question, informally? How many of these pirate companies are there worldwide?

Mr. SMITH. Well, I can tell you that the global capacity is double the global demand, and the capacity in Asia I think is in the billions of units per year.

Commissioner BECKER. Companies—how many of these companies are there in China?

Mr. SMITH. Oh, I have that number—in fact, MPAA has an estimate in Asia of the number of factories——

Ms. RICHARDSON. Excuse me. We are not aware of any Chinese pirate factories right now. When we find the pirate factories, they are shut down.

Mr. SMITH. In China, yes. I'm just talking about Asia as a whole.

Ms. RICHARDSON. In general, Asia-wide.

Mr. SMITH. We have that.

Commissioner LEWIS. Is it in the hundreds, Eric?

Mr. SMITH. Oh, yes—too many to buy unless we get a huge Congressional appropriation.

Chairman D'AMATO. Thank you.

PANEL V: COMMUNICATIONS

Chairman D'AMATO. Our final panel of the day, last but not least at all, will examine the communications industry in China. As with our prior panel, the market access prospects for U.S. and foreign films in this industry are matched by significant challenges. Television, the internet, other media firms are in the business of developing and providing content. A China open to foreign content providers will not only afford significant business opportunities for these firms; it may also help expose the Chinese population to Western culture and ideas.

As a result, the Chinese Government can be expected to place significant restrictions on the content offered by these firms in order to maintain control and social order.

How the Chinese leadership acts in this area should be closed watched as it is of great significance to the broader U.S.-China relationship and of course has central meaning to our own value system.

Our last panel is well-positioned to offer their perspectives on these issues. We have with us Roger Uren, Vice President for International Affairs at Phoenix Satellite Television, which recently became the first foreign firm to obtain a broadcast license in China; Lyric Hughes, CEO of China Online and an expert on the Chinese media and advertising market; Hurst Lin, U.S. General Manager and Vice President of Business Development for SINA.com, a prominent Chinese internet service and content provider; Stephen Hsu, CEO of SafeWeb, a proxy service that allows users to circumvent internet censorship efforts; and Laura Sherman, Communications Council at Paul, Weiss, Rifkind, Wharton & Garrison, who previously worked in international telecommunications issues at the Federal Communications Commission and the United States Trade Representative Office.

I thank the panelists for their participation. Let's go from right to left, and if you will summarize your testimony, Mr. Uren, then we'll go right down the table until we finish and then open it up to Q and A.

Please proceed.

STATEMENT OF ROGER T. UREN, VICE PRESIDENT FOR INTERNATIONAL AFFAIRS, PHOENIX SATELLITE TELEVISION, LIMITED (HONG KONG)

Mr. UREN. Thank you, Mr. Chairman.

I am very pleased to have the opportunity to come and talk here this afternoon.

At the outset, I should say that these are personal remarks rather than remarks that I make on behalf of Phoenix Television, and they draw on my experience both in Phoenix and also earlier, working in the Australian Government on a whole array of China issues. Indeed, that is why the television crew has come along, as my bosses are very keen to see what I have to say.

Chairman D'AMATO. To make sure you do speak privately.

Mr. UREN. Yes.

Rather than summarize the submission which I gave you, what I think I will do is concentrate more on the media questions which you are focusing on in this session, and if there are questions that arise out of the submission that you would like to discuss or raise, by all means, I am perfectly happy to do that, of course.

The media world in China is a sensitive one in political terms, and there are a number of reasons for this. There is the Communist tradition which goes back to the time when many Chinese were studying in Moscow and acquiring a sort of a Leninist view of the role of media and propaganda and running revolutions. And it wasn't just the Communists who acquired this; the KMT also spent a lot of time developing a propaganda apparatus and absorbing the lessons of Leninism.

There was also a very well-established bureaucratic apparatus which was created during the 1950s and which still exists in the form of the Propaganda Department in the Party and all the instrumentalities below which are designed to enforce discipline on the media. And there are a lot of people in these organizations whose jobs depend on the continuing interference of the authorities in what is written, broadcast, and seen.

These are issues that have come down as a legacy from the history of the events of the last century. Today there is a further question which is that of social stability. China is going through extraordinarily rapid changes. There are all sorts of issues emerging that create tensions in society—a gap between rich and poor, within cities; a gap between the wealthier coastal areas and the inland areas, some of which are really very poverty-stricken still—and that means that the regime, with good grounds, is concerned about what people think and what they know and so forth.

But that concern, I feel, combines with the legacy of the past, and the existence of these propaganda restraints and propaganda machinery, to create a situation that is rather inflexible; so instead of moving forward at the sort of pace that I think would be good for China politically and economically, and good for China's relations with the outside world, they are sort of stuck there, or moving too slowly.

There is also a sense of Asian nationalism which one finds not just in China, but in other countries in the region, of being suspicious of non-national broadcasters, non-national media. While Phoenix is listed and based in Hong Kong, as far as the Chinese mainland media world is concerned, it is a foreign enterprise, a foreign exercise.

We have, interestingly, the same or similar problems in Taiwan to those that we have on the mainland. The Taiwan authorities have a view of external media concerns which parallels that we encounter on the mainland. In both places, I think these attitudes are gradually changing, and they are admittedly more visible on the mainland than in Taiwan, but from our point of view, they are both serious problems.

Today in China, the media world is much more open than it has ever been in the past. Twenty years ago if you compared it with today, it is very difficult to see the similarities. In earlier days, in the 1980s, there was basically one national TV station and a couple of local TV stations. Now, official figures suggest that there are over 1,000 TV stations in China, and unofficial figures suggest that it is closer to about 10,000. The number of newspapers has also proliferated. There were about half a dozen or so newspapers published in 1980; today there are over 1,000. And that extraordinary proliferation in the number of broadcasters and publishers means that there is a lot more information available than there has been in the past. Most of it is—what should one say—uncensored in the sense that there is no one who sits there and says, yes, you can publish this, or you can't publish that, but there are instances that occur from time to time of people publishing things that the authorities consider have gone too far, and whoever is involved in that will find themselves in serious difficulty. In my testimony, I refer to a recent case of someone who published a story alleging that the wife of the head of the National People's Congress had been overly involved in business deals and so on. I can't comment on the accuracy of the story, but it is issues like that that today attract measures from the authorities.

In the past, almost anything would have attracted the authorities, anything that wasn't absolutely in accordance with the Party's guidelines. So today, there is an enormous amount of material in the Chinese press about everything from sexual fashions in other countries to problems in different parts of China and so forth, and as long as they don't get into an area of particularly sensitive subjects, no one seeks to interfere with them.

One problem that is emerging out of this, though, is that the subscriptions to the People's Daily, which is the main mouthpiece of the Party, have dropped quite dramatically. Consequently People's Daily is trying to influence through the propaganda apparatus the distribution of its competitors, because it likes to feel that it is the preeminent newspaper. And this is a function not of the leadership saying, "Look, we should make sure that only the People's Daily is heard," it is a function of an institution, i.e., the People's Daily, trying to protect a position that it has occupied for a long time, protect it at a time when Chinese society, the Chinese economy, and indeed the Chinese political environment is changing very rapidly.

The same thing applies to the television industry in China. The established state television companies are increasingly concerned about competing with companies like Phoenix, for example, from outside China, or with some of the more enterprising local and regional Chinese television stations.

CCTV has a advertising revenue of about $660 million per year, and that is a lot of money to have coming in, and they are keen to protect that. So you have now, as a consequence of economic growth, politics and commercial interests flowing together in a way that generates a desire on the part of components of the system to exploit the apparatus that has come down from earlier days to maintain their commercial edge.

I think this is a transitional phenomenon, and the apparatus that has been inherited is not going to function effectively forever, and in the eyes of many people it is already completely discredited, and a lot of people just don't take any notice of directives that come out and so forth. But I wouldn't want to leave the impression that it is totally ineffective. Officials in the propaganda machinery have a real capacity to do something if they wish, but usually from their point of view, the problem of controlling the media is so big that they can't control everything—they have to be selective.

WTO itself does not have a direct impact on the media industry. Because of the political sensitivity of the media industry, the Chinese were very keen to keep it out of the WTO agreement. But as we were discussing in the earlier session, it does have implications for the film industry, and perhaps with the chair's indulgence, if I could just comment on the earlier discussion to say that I agree completely that the number of foreign films coming in will expand quite considerably. One reason for that is that for those Chinese who are concerned about politically sensitive issues, it is very difficult to find in a foreign film something that they consider really politically sensitive. It is the Chinese-produced films that are oriented at Chinese subjects and reflect Chinese concerns that touch nerves. So they are very happy to have some large Hollywood company come in and make a blockbuster about the quaint, exotic character of Buddhist traditions in Sichuan, for example, but don't like Chinese producers to produce and to have Chinese direct films about marriage and divorce in modern China today in the light of current circumstances or something like that.

Chairman D'AMATO. Please summarize if you can.

Mr. UREN. Yes, sorry, Mr. Chairman.

The authorities are at present trying to keep the lid on or circumscribe the access that satellite television has. We broadcast across China and are picked up by a lot of people who have their own satellite dishes. We are also received by universities and by government agencies that have a foreign aspect to their work. And as you mentioned before, we now have a license to download into the cable system in the Pearl River Delta area, which is a positive step, and certainly one that we welcome, but not an enormous step. But we would like to see the situation open up much more. At present, the propaganda apparatus is trying to close down all satellite reception that is not strictly within their own guidelines. That is not going to work, and it is not going to be sustained for a long period of time simply because the demand and the requirement for information about the outside world is very substantial.

So my expectation is that we will see gradual movement forward where there is a sort of stop and start process, with parts of the system trying to close some things down and then other parts of the system pushing to open them up, and that the imperatives of the economy mean that China has to be more integrated with the outside world, and integration of the outside world is certainly going to be successfully implemented if you have a much freer flow of information in both directions.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF ROGER T. UREN

The invitation that was extended to me expressed an interest in my views on a wide range of issues, including many related to the impact of China's accession to WTO. Before addressing the issues you have expressed an interest in, however, I should say something about my own background.

I am currently the Vice President for International Affairs of Phoenix Satellite Television. Phoenix is a Hong Kong-based television company that broadcasts in Mandarin Chinese across East Asia, with a special focus on mainland China. Phoenix also has North American and European services, and is seeking to create a global Chinese-language television network that provides Chinese everywhere with current and independent news and commentaries about recent developments. I have attached a brief note on Phoenix which outlines its general philosophy, corporate structure and place in the Chinese media market.

The views that I set out here, however, reflect my personal assessments; they are not necessarily the judgments of the management of Phoenix. These views take into account my sense of China from the perspective of Phoenix Television, but they also draw on my earlier experience in dealing with China and studying Chinese language, literature, culture and politics over the last three decades, first as a university student and subsequently as a diplomat in the Australian foreign service who served as a language officer in China, as an author of several books about China, and finally as assistant secretary managing the analysis of Asian affairs at the Office of National Assessments, Australia's premier agency for assessing international political, strategic and economic developments.

These introductory comments make it clear that I am better qualified to address some questions rather others, and consequently I will focus on four specific issues: the implications of the reform process; WTO implementation; the place of the media; and the international dimension. I will conclude with some consideration of the prospects for greater media freedom.

Reform, Intellectual Pluralism and Modern China Watching

Since the late 1970s China has been undergoing a process of fundamental economic reform. This process has also generated significant social, cultural and political change, touching to varying extents every corner of Chinese society. In many respects China is still passing through a transitional phase, however, and what shape China will take as the changes currently underway begin to assume a more settled and permanent form remains to be seen. During the last century Chinese history underwent a series of sudden discontinuities, and China's experience during that century is a reminder that one cannot predict China's future by making straight-line projections based on trends over the last decade or so, or by imposing analytical models that derive from non-Chinese experience and overlook China's unique character. One has to look more closely at the dynamics of Chinese government and society, and the interplay between domestic and foreign factors, in order to assess the direction of China at large.

The fundamental economic changes that have taken place in China have not been matched by commensurate systemic political reform. Although the Chinese political environment is now vastly different from that which existed as recently as the 1980s, and Chinese citizens today have a much greater array of personal, religious and cultural freedoms than they have enjoyed since the founding of the People's Republic in 1949, the political system itself has not changed in an organic or structural sense. The Communist Party continues to have a monopoly on national political power, and while senior Party leaders are more responsive to public opinion than they have ever been in the past, they consistently seek to stifle calls for the introduction of democratic forms of government at the national level.

Despite the slowness of movement towards democratic political change, however, economic reform has brought about widespread decentralization of power over the last decade. Political authority in China, while still responsive to orders from the central government, is now much more diffuse and layered than it has been since the pre-Communist period. Provincial, city and township governments have much greater autonomy. A similar diffusion of authority has occurred horizontally, and on almost any particular issue the Chinese political public presents a diversity of attitudes: at one end of the spectrum old-style ideologues still advocate socialist policies, while at the other end large number of returned students and entrepreneurs promote capitalist and democratic solutions to China's problems.

On the periphery of the political mainstream are many smaller and yet still influential groups and individuals: there are numerous religious and quasi-religious sects propagating various views of the world, from those spawned by the revival of Buddhism through underground churches to the Falungong, which in 1998 sought to mount a direct challenge to government authority. There are also networks of neoconservative politicians and intellectuals, who espouse a form of nationalistic capitalism, and who often portray the United States as seeking to undermine China's prospects for economic success. A book published in the mid-1990s, *The China That Can Say No*, is a typical expression of their attitudes.

The proliferation of attitudes, opinions and beliefs that has occurred during the past two decades has important implications for how China operates as a society and state today. For one thing, this diversity of views tends to impact on Chinese politics and governance in two different, contradictory ways: the debates that now often occur promote a sense of democracy and personal freedom, but at times the very multiplicity of views and the lack of consensus reinforces the tendency of the regime to impose policies and solutions on the state at large; political processes have not evolved sufficiently to be able to reconcile differences of opinion through consultative mechanisms, and consequently the central leadership tends from time to time to issue edicts that it expects to be followed by the entire country.

But central government orders are not necessarily implemented fully or uniformly. Moreover, irrespective of government directives, different views continue to flourish, creating a pluralistic environment in which it is increasingly difficult for the government to impose solutions that ignore public opinion.

This means that it is often misleading to use the words "China" or "the Chinese" as if they denoted a single, unitary actor. One can find in China people who will espouse whatever view one would like to hear. The trick of modern China watching increasingly lies in distinguishing the fringe from the mainstream, and then working out how much is posturing designed to advance careers or institutional interests and not indicative of real attitudes and intentions.

The Government Response and WTO Compliance

The Chinese government appreciates that continuing reform is necessary to sustain the economic growth that is essential to maintaining social stability and to realizing China's ambition to become a modern state. At the same time, however, the

Chinese authorities realize that reform has produced many sources of instability. These range from macro-economic structural factors such as the growing wealth gap between the coastal provinces and the hinterland and between the entrepreneurial class and the lower levels of urban and rural society, to the increasing access Chinese have to foreign news and information and the diminishing effectiveness of the Communist Party propaganda apparatus in shaping popular opinions and views. The Chinese authorities consequently seem to be performing a balancing act, on the one hand taking at times quite bold steps to maintain economic growth, while on the other hand trying to prevent the reform program from undermining social stability and perhaps eventually even the foundations of the regime.

The tensions which pervade the government's mode of operation are reflected in the Chinese approach to WTO. The Chinese government, and a large part of the Chinese public, is extremely gratified that China has finally been accepted into the WTO, which is seen as recognition of China's status as a full member of the international trading system. Besides releasing a sense of national pride—the 2008 Olympic decision had a similar effect—WTO entry is also welcomed as a step that will enhance Chinese economic prospects. Elite economic policy makers also regard it as providing a rationale for further economic reform.

The Chinese approach to the requirements of WTO membership is more complex. While national leaders and central government ministries understand the implications of WTO and expect to implement China's commitments fully, at the local level many agencies are unfamiliar with the requirements set out in the WTO agreements. The customs authorities in many areas are unclear what tariffs apply after WTO entry. This problem is further exacerbated by the authorities' slowness in publishing a Chinese translation of the WTO agreement. The sensitivity that they attach to this was underscored when a Shanghai publishing house was prevented from publishing its own translation of the WTO documents by the central propaganda apparatus.

Many local authorities will continue to take an approach that favors local interests, just as they did before China entered WTO. This is not a sign of a lack of national commitment to WTO, but a consequence of the process of decentralization of power and the difficulty of ensuring that regions and localities follow central government policy. While directives from the central government on matters of great importance are generally observed at the local level, on issues of more limited significance, especially those touching on local, economic interests, provincial and lower level officials tend to disregard or even deliberately undermine central directives.

The problems that are likely to result from this situation are not intractable, but require sensitive and special handling. The WTO has a disputes mechanism whereby aggrieved parties can protest at the action of others, but in many instances resort to these processes is likely to delay rather than facilitate resolving China-related problems.

A more effective approach might be to establish a joint commission that could receive complaints about non-compliance with WTO provisions and then investigate them with a view to bringing them to the attention of the central authorities without the risk of one side or the other adopting an inflexible position in a public disputes forum. A bilateral review mechanism could also, of course, consider complaints about non-compliance on the part of the United States as well. In short, a mechanism that initially handled non-compliance in a low-key style and involved officials from both sides would be able to clear away many of those cases that resulted from local officials ignoring or resisting the wishes of the central authorities.

The Media Today: Freedom of Information v. Old Habits

The terms of China's entry to WTO have little direct relevance to the Chinese government's handling of information and the media. Apart from requiring that the quota of foreign films admitted each year into China be increased from 10 to 20, WTO does not contain any provisions that call for greater freedom for the media or for the general flow of information.

But the dynamics of reform have inevitably involved a large measure of opening up to the outside world, and this has progressively created a much freer environment in which the media operates. An enormous quantity of information about both China and the outside world is now available in China. The widely shared realization that economic modernization requires a relatively free flow of information has given great impetus to the process of intellectual liberalization.

Another important driver has been the success of China's economic reform program in creating an entrepreneurial community, which has led to a proliferation of media, publishing and information businesses. The commercialization of the media, and the spectacular growth of advertising, has made the media and publishing businesses extremely lucrative. As a consequence China today has over 1,000 television stations, and probably more than 2,000 newspapers. The sheer numbers involved make it difficult for the government to enforce standards or even monitor the content of the regional and provincial media, opening the way for a much broader array of news and opinions to be aired. The popularity of the local print media is so pronounced that the *People's Daily*, the Communist Party's main mouthpiece, has recently begun to experience difficulty in maintaining its circulation. A signed commentary article in the *People's Daily* on 31 December last year addressed this problem, and accused local officials of engaging in "local protectionism" and being concerned with "local interests" and "departmental interests."

The revolution in information technology, and especially the internet and satellite television, has also accelerated the freeing up of the information world in China. While the authorities have blocked a number of foreign news organization web sites from being accessed through Chinese internet service providers, it is virtually impossible for government agencies to censor e-mail traffic, or indeed prevent Chinese citizens with the financial capacity to make international telephone calls from logging directly onto foreign web sites by making IDD calls to Hong Kong or other external locations. As a consequence the Chinese media is under considerable pressure to provide news and information that at least on the surface is broadly comparable with that available outside China, although a considerable gap often exists between what appears on Chinese news services and what is available internationally.

But the Chinese government remains especially sensitive about the free availability of information and appears to be committed to maintaining the capacity to control the media and publishing worlds. This situation is the product of a range of factors, one of the most significant of which is the legacy of the Communist system, and the impact of Leninist concepts of political control that were prevalent in China from the 1920s onwards. This legacy has attached great importance to the role of propaganda as a means of influencing public opinion and exercising political control over society. The Chinese Communist Party continues to maintain a Propaganda Department, which sets policy guidelines for the State Administration of Radio, Film and Television, a government agency which is responsible for supervising the media and publishing world. With a key transition in political leaders occurring later in 2002, the propaganda machinery seems at present to be unusually active in trying to control over the media.

This sensitivity to media issues is also conditioned by a strong sense of the "foreign" or "external" identity of the international media. This phenomenon is part of a broader Asian paradigm, and other countries in the region have a similar sense of being distinct, national entities that only accept external media, cultural and informational products on a selective basis. This mentality is reflected in the Republic of Korea's exclusion of Japanese cultural products, including films and music. It is also illustrated by the Taiwan government's refusal to allow Phoenix Television to be downloaded and distributed in Taiwan by a local cable provider. As long as this sense of the need to contain or at least filter "foreign" influences persists in the region the Chinese government will feel that it can afford to take a conservative and restrictive approach to opening up to foreign sources of media, information and culture. Taiwan, being a Chinese society that only in the 1980s dismantled the mechanisms of media control inherited from pre-Communist mainland China, still takes a more restrictive approach towards outside media than to domestic media.

This reality is illustrated by the situation that Phoenix finds itself in. Although Phoenix is based in Hong Kong, which is now under Chinese sovereignty, the Chinese government still considers Phoenix as a foreign entity, presumably because the government in Beijing is conscious that under the terms of Hong Kong's return to mainland sovereignty it cannot directly control the content or orientation of the media in Hong Kong. Consequently the propaganda apparatus continuously seeks to curb Phoenix's access to the mainland audience. The authorities in Taiwan also take a similar approach, and have sought to use a law governing the entry into Taiwan of cultural products from Hong Kong and Macao to stop Phoenix being broadcast in Taiwan. Both systems treat Phoenix as a "foreign" entity.

The economic impact of the reform process, and the commercialization of much of the media, has also created new motivations for the government to maintain control over the media. In particular the government is keen to maintain the commercial viability of major state-owned media entities such as the central television system (CCTV). During the last decade CCTV has developed a very considerable advertising revenue, which in 2000 amounted to some US$662 million, far outstripping the mere US$3.6 million that the central government contributed to CCTV during the same period. But CCTV is in many respects a highly bureaucratic organization which lacks the flexibility to deal with serious commercial competition, and consequently it looks to the government apparatus to maintain its market share and its advertising revenue. For its part, the government regards media controls as effective means of protecting CCTV's revenue.

The Chinese government's continuing desire to maintain control over the media has recently been manifested in a concerted attempt to limit the reception of satellite television programs in China. During recent weeks the State Administration of Film, Radio and Television (SARFT) has been dismantling satellite dishes in Beijing and other major cities that have been erected without official authorization.

The SARFT has also been planning to create a uniform satellite platform, whereby all foreign satellite programs will be broadcast from a Chinese controlled satellite to a Chinese audience that has been authorized to receive foreign television programs. The reason for establishing this platform is that it will enable the Chinese authorities to control the downloading of satellite signals, and thus turn off any broadcaster that is regarded as broadcasting views or information that is unacceptable to the government.

But conscious that it cannot simply stamp out foreign satellite broadcasters, the Chinese government has at the same time given permission for three foreign TV broadcasters, including Phoenix, to download programs in the Pearl River Delta cable system. This appears to be a calculated gesture, however, conveying a sense of openness to the external media, while only giving a geographically restricted market that is unlikely to have any impact on broad, nation-wide attitudes.

The domestic Chinese film industry is the target of a similar desire to control what is put before the public. Indeed, some observers consider that the Chinese film industry is more tightly controlled now than it was fifteen years ago. In recent years there have been a number of instances of Chinese films being awarded prizes at international film festivals and yet not being permitted to be distributed in China. One film that suffered such a fate, The Devils Are Coming, recounted how a group of Chinese villagers successfully resisted Japanese invaders during the Sino-Japanese War. The problem for the propaganda apparatus was that the villagers' victory was won despite the absence from the story of any Communist Party members or soldiers of the People's Liberation Army to provide the peasants with leadership.

While local film production has to avoid sex, violence, and sending the wrong political message, China is increasingly open to joint venture-productions involving large Western film corporations. The fact that many foreign-made films are Western in terms of perspective and story line, and use China as an exotic backdrop almost devoid of contemporary content, means that they are much less likely to jar with the sensitivities of Chinese politics and society. They also involve relatively large financial investments in China.

The Chinese government seems to be less concerned about the print media, presumably because its impact is more local in character and effects fewer people. An enormous number of daily, weekly and monthly publications are now available in China and for most of the time the government seems prepared to rely on the good sense of editors and publishers to avoid unacceptable material.

Nonetheless the authorities continue to suppress issues of news publications that contain information considered to be particularly damaging to the interests of the government or of senior leaders. All copies of a recent issue of Securities Weekly, for example, were seized because it contained an article alleging that Zhu Lin, the wife of Li Peng, the chairman of China's National People's Congress, was involved in improper business dealings. The author of the article was also reported to have been arrested. The propaganda apparatus also suppresses certain books. While James Joyce's Ulysses, banned for many years in the United States, is now available in a newly completed Chinese translation, the writings of Gao Xingjian, the Chinese Nobel laureate who has lived in virtual exile in France for over a decade, are not available in China—less because of any explicit anti-government views than because the propaganda apparatus finds it difficult to concede that it previously suppressed works that have earned China its first Nobel Prize for literature.

While it is unrealistic to expect the Chinese government to permit the publication and distribution of material that directly attacks the regime or propagates dissident perspectives, a much freer media and information environment would provide important benefits for China and the region at large:

—In terms of economic development, a freer media environment would make a significant contribution to enhancing transparency in commercial and business dealings. This would be a deterrent to corrupt practices, and would also help China to avoid the sort of excessively close government-business linkages that were one of the main causes of the 1997 East Asian economic crisis.

—A freer media would facilitate a greater understanding of the outside world by Chinese society at large. Although the number of Chinese with direct and extensive experience of the outside world is now much greater than it was a decade ago, many Chinese continue to have a limited knowledge of the international community, and especially of the way Western political systems operate. This impedes the process of building linkages between China and the outside world, but also creates an environment in which nationalistic neo-conservative intellectuals can spread their own distorted views of the West.

—An unrestricted flow of information about developments in Taiwan would contribute to reducing the likelihood of any crisis breaking out in the Taiwan Strait. While China now has a better understanding of Taiwan politics than it did less than a decade ago, a more thorough knowledge and understanding of Taiwan would help ensure that China did not unintentionally put itself in a position that caused a cross-Strait crisis.

—A greater flow of information and entertainment would provide a potentially important source of nourishment for Chinese intellectual and cultural life, thereby facilitating further social and economic development and providing an outlet for social and economic frustrations that could otherwise generate serious social disorder.

In short, a freer media has the potential to perform a constructive and positive role in China, contributing to healthy economic development, domestic social stability and peaceful external relations.

Mainstream Chinese Perceptions of the Outside World and Media Freedom

Pervading Chinese government thinking about the media is the fundamental issue of China's relations with the outside world, which draws together China's desire for economic modernization, the fear of a breakdown in social stability, the perennial question of Taiwan, and its interest in maintaining its own national security. The mainstream Chinese political community's approach to the outside world is shaped by five major factors:

—The desire to see China accepted as a major power on the international stage. This desire is conditioned by China's view of its historical role as the most powerful state in East Asia, but is not a retrospective desire to recreate the "middle kingdom." The modern Chinese approach is more related to being accepted as a nation state that is respected by other states as a responsible and pacific influence on the global community.

—The realization that China's economic development, which is essential for the survival of the regime, requires stability on China's borders.

—The related realization that the modernization of the Chinese economy cannot be achieved without a high degree of integration with the outside world, and in particular with the United States and other developed Western countries, which represent the bulk of the world's markets and are major sources of investment funds and high technology.

—The aspiration to effect the reintegration of Taiwan into a single Chinese polity, not for economic or strategic reasons, but because of the impact of history on China's sense of national identity. Despite China's refusal to renounce the right to use force to resolve the Taiwan issue, tension between the two sides is minimal compared with other divided states. But while conflict would only occur if one of the parties seriously mismanaged the situation, the political imperatives facing both governments complicate rational policy making in Taiwan and the mainland.

—The commitment to maintaining China's security from external threats. From 1959 through to the end of the Cold War this was directed against the perceived threat from the Soviet Union, but during the 1990s is no longer focused against any single perceived adversary. Some elements in the Chinese governmental system argue in ways that highlight specific threats, such as a possible revival of Japanese militarism or a perceived U.S. intention to weaken and "contain" China, but other parts of the system have a broader view that sees potential security problems having a multi-dimensional character and not being focused on any specific country.

These factors each contribute to shaping the Chinese government's approach to the media. China's deep desire to be recognized as a sovereign state leads it to react negatively to external pressure, especially when deployed in public, to change its internal arrangements. But its need for expanded economic ties with the West make a freer flow of information essential, although this is inevitably moderated by concerns about social stability and the need to maintain the dignity of the state and its leaders. Similar concerns about national dignity condition attitudes to the Taiwan media, while Taiwan's approach provides a justification for China's policy of controlling the access of the foreign media to China. And perceptions that Western powers might seek to "contain" China sometimes convinces its leaders that they must curb the Chinese public's access to foreign media and information lest it be used by hostile powers to undermine or subvert the Chinese government or political system.

The Outlook for Media Freedom

The liberalization of the Chinese government's treatment of media and information is thus a multifaceted process, shaped by a set of often conflicting domestic and international factors. The cumulative impact of these factors, however, and in particular the priority attached to economic development, means that the underlying trend is towards greater openness to information from the outside world, irrespective whether this comes via modern communication technology such as satellite television and the internet, or by more traditional means such as the print media, books, overseas travel by Chinese, and the ever increasing number of foreigners visiting and residing in China. This process will sometimes move forward with sudden and sweeping movements, but at other times go into reverse as a consequence of any one of a number of factors.

But in the longer term China will inevitably be pulled in the direction of greater media and press freedom. The advent of a new generation of political leaders following the Sixteenth Party Congress in October 2002 will introduce a measure of new thinking, as will the retirement of some of the more conservative officials from the propaganda and cultural apparatus. But forward movement will be uneven. The sense of the importance of the media and of information to social stability is deeply ingrained in modern Chinese political culture, both in Taiwan and on the mainland, and the pressures on government to retain the capacity to control the media will remain strong for at least the next five to ten years.

ATTACHMENT: A BRIEF INTRODUCTION TO PHOENIX SATELLITE TELEVISION

"As the Chinese connection, Phoenix Chinese Channel is the window to the world for the Chinese global community and is renowned for its international quality and unique presentation." Source: The Television Asia Satellite and Cable Annual Guide

Phoenix is a Hong Kong-based television broadcaster that seeks to promote a free flow of information and entertainment within the Greater China region. In effect Phoenix is a key player in the process of bringing to China the media freedom that is a natural consequence of China's economic reforms.

Phoenix features a broad mix of programs, ranging from political and economic news and current affairs through talk shows and film and music reviews to movies and miniseries of both Chinese and foreign origin. Phoenix, which broadcasts in Mandarin Chinese, draws its presenters from different parts of mainland China, Taiwan and in one case from Singapore.

The CEO of Phoenix, Mr. Liu Changle, consequently describes Phoenix as a TV broadcaster that is different from mainland channels, different from Hong Kong channels, and also different from those on Taiwan. Phoenix seeks to transcend the various components of the Greater China and offer Chinese viewers a media service that is global in outlook and independent of local political attachments.

Phoenix broadcasts internationally, and is distributed by cable in Southeast Asia and by satellite in Europe and the U.S. But its largest audience is mainland China, where it reaches over 40 million households, according to a survey conducted by the State Council Statistical Bureau. This equates to more than 130 million viewers.

Phoenix is a public company free from the control of any government. Phoenix is listed on the Hong Kong Growth Enterprise Market, and its two largest shareholders are News Corporation and Today's Asia, a company that is largely owned by the CEO. These two corporations own over 75 percent of Phoenix. Public investors own 16.4 percent of the company. The sole government shareholder is The Bank of China, which only holds 8.4 percent.

The Phoenix news service is watched by many senior Chinese leaders and officials, who regard it as a valuable source of international news broadcast in Chinese. Phoenix is the only foreign TV channel broadcast in the Foreign Ministry canteen.

Chairman D'AMATO. Thank you very much, Mr. Uren. I know that we're going to have some questions for you.

We'll move now to Ms. Lyric Hughes, CEO of China Online.

STATEMENT OF LYRIC M. HUGHES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHINA ONLINE, INCORPORATED

Ms. HUGHES. Thank you, Mr. Chairman.

China Online is the leading source of China-related business news aggregated from Chinese language sources. Our content can be found on our own website, Chinaonline.com, and we also syndicate our content to Reuters, Dow Jones, Bloomberg, and so forth.

We just started 3 years ago, and we have been able to take advantage of some of the difficulties in the Chinese media to create a company.

I agree very much with Roger that WTO is not really a factor in the broad liberalization that has gone on in the media markets in China, and when Roger was speaking, I was reminded too that our market—all media markets—are sensitive and have restrictions on foreign ownership. Roger's boss a little while ago actually changed his citizenship so he could buy Fox TV, I think was the original idea.

Mr. UREN. One of the shareholders.

Ms. HUGHES. One of the shareholders, yes; thank you—one of the prominent shareholders.

So these kinds of restrictions exist in our own market as well.

What I'd like to do to summarize my testimony is just give you my conclusions. I started working with the media in China in 1979, which was the first year that I visited a newspaper there, and I have done business with them ever since, so I think I have a pretty good idea of how the media works in China.

My first conclusion is that out of the top ten media companies in the world over the next 10 years, two of those ten will be Chinese language-based media companies. So Hollywood won't rule forever, because a lot of this stuff is culturally-based and because the market in China is just so big.

For example, the television market there is over 100 million cable households today—that is versus 70 million in the United States today. So China is already the biggest market there.

Advertising spending will continue to increase, and that is because China's economy is still growing at a rate of 6 to 7 percent. Our economy isn't growing as much; we have fewer people, and there is no way that China won't be the world's biggest media market.

Print publications, for example, have exploded. When I first went to China, there were a couple thousand print publications; now there are 8,000—and that is in a highly-regulated industry.

Commissioner LEWIS. That is newspapers, magazines, everything?

Ms. HUGHES. Everything. So we are increasing.

And foreign media companies I think will still be restricted as they go into China until the consolidation that is taking place today in China's media industry is more complete, and those Chinese media companies will be able to compete with the foreign media companies coming in. So this will be a protected industry.

Technology has opened new horizons for both the Chinese media and outsiders interested in China. Our company is an example of this. Investment in the news sector in China—and this was just reiterated a couple days ago—will not be allowed by foreigners. However, because of the internet, we distribute our news content about China around the world. I think it is quite interesting—on any given day, 20 to 25 percent of the people who read our English language site are Chinese speakers within China. So we are reaching people even though the regulations do not on their face allow it.

Commissioner LEWIS. What number would that be for your Chinese readers?

Ms. HUGHES. Tens of thousands; so it is a significant number.

As I have mentioned, too, media around the world is primarily funded by advertising. When I first went to China, the total advertising spent was only $5 million; it is projected to be $12 billion this year. So it is one of the only places in the world there this is still growing, where advertising is growing right now because of economic conditions in China.

However, content might be king, and Hollywood might think that they are the ruler of the universe, but in China, Chinese language content is absolutely necessary. So an area to invest in would be in translation services for content for American companies going in.

Intellectual property barriers are definitely there, but after listening to the other panel, I worked as a consultant to some of the film industry, and what I recommended to them was that they think about changing their model. Sometimes it is easier to change your business model than behavior patterns and laws.

So what I would recommend is that Hollywood not do the same type of distribution—what they call the Windows distribution system, where first, you have theatrical exhibition, and then you go to VCDs, and then you go to television. In China, because there are many, many more people who are reached by cable television than have access to a movie theater, I think the way to do it there would be to place first-run movies in China the same day they are shown in theaters in the United States and to support that with advertising. I think that would then lead to a very profitable way to show American motion pictures in China.

The number of cable stations in China is exploding. People need more content. Why don 't we change our way of dealing with things, and then you would put the DVD and VCD pirates out of business over night, because everybody would have already seen the movie.

So I think we have to think out of the box, and just because a way of doing business has been very profitable in the United States doesn't mean it will work that way in another country, especially when that country does not have a good infrastructure to work with.

On the internet, obviously, that is a key interest of mine, and I'm sure you will be hearing from Hurst about it as well. But again, I do not believe that the internet in China will grow the same way it has in the United States, with a fixed-line phone attached to a PC. Today in China there are 140 million cellular phone subscribers, and within this year and next year, every, single one of them will be attached to the internet. Also, in cable television, there is a great broad band movement in China, both within the school system and within the municipal governments to bring broad band to television.

So I think most people in China will first find the internet on their television in their living room, or on their cellular telephones.

Finally, I have been to study the internet and the growth of the internet in about 35 countries, from Zimbabwe to Germany to here in the United States, and what I have found is that issues that we consider very important and focus on—for example, censorship—

and I counted, and the New York Times has had 24 stories in the last 20 months on censorship in the internet in China; that's what they focus on—but really, what leads to the internet's growth are public policy issues that are more important than that.

For example, it is very cheap to access the internet in China. It is very expensive to do so in France and Germany. Therefore, it will be expensive for people to do that. But it is very competitive now in China. The ISPs are competing. And I think that that public policy decision to make access cheap is more important than any kind of content control that you can possibly imagine.

Also, by the way, I did have a chance to interview China's Finance Minister, and I asked him, "Do you plan to tax the internet in China?" He said, "Well, you know, Lyric, I used to be the head of the Taxation Bureau, so it is very hard for me to say that I don't want to tax something. However, we have looked at the model in the United States—cheap access and no taxation on the internet—and that is what spurred growth in the U.S., so we are going to follow that model."

So there are many positive policy developments in China that people have not paid attention to, I believe.

So all media is biased, all media is culturally bound to the country and the people that it stems from, but there will be great opportunities for U.S. companies, since that is a key competency that we have, to take content into China. We just have to figure out how to do it better and faster and smarter than all the competitors.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF LYRIC M. HUGHES

Chairman D'Amato, Commissioners, thank you for allowing me the opportunity to relate to you my experiences with the media industry in China, as part of your efforts to examine the impact of China's recent accession to the WTO on U.S.-China trade relations.

Strictly speaking, the liberalization that is taking place in China's media sector is unrelated to its entry into WTO. The key WTO concession gained was to allow more foreign films to be exhibited in China, in response to heavy lobbying from Hollywood.

According to the trade agreement:

> The country did not promise to open its radio, film and TV sectors to foreign competition. Foreign investment will remain forbidden in these sectors as well. However, China did agree to import 20 foreign movies every year and will allow foreign investors to participate in renovating, building and operating movie theaters. It will also allow imports of foreign radio, film and TV programs and joint production of these programs by Chinese and foreign companies. (China Online, December 6, 2001)

As James Kynge wrote in the Dec. 31st, 2001 issue of the Financial Times, "Beijing saw the media as too sensitive an area to be formally thrown open to foreign capital as part of its WTO succession deal."

Despite this restriction, market forces are accelerating rapid change. Kynge quotes Prof. Yu Gouming, at the College of News at the People's University in Beijing. "There will be greater plurality of ownership in the media and the media will become more market-oriented." Indeed, China's domestic media industry is headed for a period of internal consolidation which will lead to new alliances and which will change the competitive landscape for Chinese and foreign companies alike.

As China Online reported on December 6, 2001, this process has already begun. The China Radio, Film and Television Company is China's newest media conglomerate, with annual revenues of $1.2B and media assets valued at $2.6B.

At the same time that China is aggressively pursuing internal consolidation of its media industry, we should not expect China to fling open its doors to foreign investors.

As Credit Suisse reports, (December 7, 2001 CSFB Edge) "We see no 'big bang' deregulation of China's media market anytime soon." Instead, China will allow specific companies to pursue fairly vague projects, and then allow these projects to go forward on a case-by-case basis. In China, they call this playing on the white line of the ping-pong table.

AOL's recent deal with Legend Computer is an example. Imagine Dell Computer with an ISP license—that is the company that AOL has tied up with in China. However, just what they are going to do together is still unclear, and this is deliberate. Regulators in China are still struggling with the impact of technology on their ability to control media access in China.

In its December 5th, 2001 brief on *Foreign Broadcasters* in China, Oxford Analytica concluded the following:

> Over time, the huge potential for foreign media investment in the Chinese market may progressively transform official attitudes from regarding broadcast media as a propaganda tool, to developing it as a commercially driven business sector. However, for the foreseeable future, the government's overriding desire to maintain a tight grip on public access to information means that the liberalization of this sector will significantly lag behind other areas of the economy.

In spite of these obstacles, why are foreign media giants so focused on China? In a word, advertising. In a year of an expected worldwide downturn in adspend (have you noticed how thin magazines have gotten recently?) China's ad business is booming, and will continue to boom as China heads towards an advertising bonanza with the 2008 Olympics in Beijing.

When I first visited China in 1979, advertising, which was invented in China, had just been reallowed by Deng Xiaoping in 1978 and was then a tiny $5M a year business. In southern China, where I began my work with the Chinese media, I was in the heart of the reform country, and I found that every newspaper I spoke to was eager to get advertising from U.S. companies. Fast-forward to 2002, and advertising revenues in China are expected to be $12B this year. And there is plenty of room for growth—adspend per capita in China is still half of what it is in Thailand.

No media market in the world has ever expanded as fast as China's. In 1980, there were about 2,180 print publications in China. In 2000, there were over 8,000. (*Lyric Hughes, Online Publishing and News: A Publisher's Perspective, China's IT Policy & Legislation, Vol. II, Trans-Asia Publishing, 2001.*) Some other useful media and IT statistics to give an idea of the scope of the change:

China today is the world's largest cable television market. Quoting from CSFB's Dec. 7, 2001 report, *China's Broadcasting Sector*: "TV penetration in China is mature, with ownership of television sets at around 95% of total households, or exceeding 300 million units." The same report says there are 90 million subscribers to cable TV, representing a 27% penetration rate of households. This compares with about 70 million cable households in the U.S. market.

China is also the largest cellular telephone market. There are currently 140 million cell phone users in China, according to official statistics. By comparison, there are approximately 132 million cell phone users in the U.S.

Internet usage is also expanding rapidly. At the end of last year, Wu Jichuan, the Minister of Information Industry, told *China Daily Business Weekly* that there are 15.91 million terminals connected to the Internet in China as of last November. Since one terminal is usually used by three people, Wu estimated that there are probably more than 45 million actual users.

Internet usage has been seemingly hampered by the lack of residential landlines. Given China's huge base of cellular phone users, as the wireless Internet becomes a reality, I believe China will also become the largest Web user in the world more quickly that has been forecast. Current official forecasts are for 80M users by 2003.

The question remains, will government regulations and censorship hamper further growth? The western media has too often focused either on the public offerings Chinese ISPs and censorship issues, ignoring some of China's rapid uptake of technology. The New York Times has published 24 stories about censorship on the Internet in China, so naturally this becomes an issue we focus on.

According to industry analyst Paul Budde in Australia:

> A special committee has been set up to investigate the ramifications of the Internet on China. Censorship is a major concern and politically subversive or pornographic material available on the Internet was dealt with

> early. The State Council issued a statement calling for the 'good use of the Internet' and 'effective measures to deal with it.' Censorship issues concerning all information on the Internet are dealt with through restrictions on Internet international link points. International links are through the MPT and transmission of pornographic or subversive material is a punishable offence. All new interactive networks require government approval and plans are underway for electronic monitoring of all network transmissions. Government restrictions are easing in certain areas and improvements made to the legal system.
>
> In early 1999, the Shanghai Posts and Telecommunications Administration (SPTA) imposed a ban on computer news services, ordering paging and computer information vendors to cease disseminating political news. SPTA claimed some news companies provided information that was pornographic, superstitious or harmful to state security. Publication on the Internet has been made dependent on State permission. The Shanghai government has also banned the posting of what it termed inflammatory information on Internet notice boards.

Yet, Australia's broadband deployment policy, and regulations on broadband content, is more restrictive than China's. China is moving ahead rapidly with broadband content agreements and there should be many opportunities for U.S. firms. In November last year Hong Kong's TVB signed a major broadband content deal with Shanghai Telecommunication. Broadband is seen as a tool to expand educational opportunities beyond China's Eastern seaboard. Today, China is the largest distance education market in the world, and U.S. companies in this sector should also be able to benefit—in most cases their content is non-controversial and is not subject to censorship. A fascinating example is Disney, which recently started charging for its Chinese language educational website, Disney.com.cn. A half year-membership costs 80 Yuan, about $10.

Against this backdrop of the media industry in China, I would like to tell you about my specific business experience in China, and how I see the future of the media, specifically the Internet, evolving. We do operate in a controversial content area, news. The fact that my company, China Online, exists at all, and our site is not blocked in China, is probably due to the fact that we are English-language and our news focus is on business, rather than politics. However, we do gather news in China, and as Orville Schell, Dean of the Journalism School at Berkeley, and a noted China scholar has described China Online, we really are a canary in the coalmine of the Chinese media. If we were ever shut down, if our operations were ever interfered with, this could be viewed as a very negative indicator for U.S.-China relations.

However, because we are a U.S.-based company, with editorial offices in Chicago, there is really not much the Chinese government can do to interfere. To quote Stanford Law Professor Lawrence Lessig in his new book, The Future of Ideas:

> How much should someone in one country have to be burdened by the laws of another country? For example: Imagine the Chinese government telling the American site China Online that it must shut down until it is able to block out all Chinese citizens, since the content on China Online is illegal in China.

In point of fact, although 20% of our readers are Chinese-speakers within China, we have never been contacted by the Chinese government about any of our news reports. So we cannot say that we have been directly affected by censorship, although if China's market were completely open our editorial offices would be in Beijing, not Chicago. So we exist in the margins of the current regulatory framework, aided by a technology that is difficult to control even within your own jurisdiction.

In another important sense, my company, China Online is in reality a beneficiary China's entry into the WTO. Let me explain. We collect articles in the Chinese media as part of our intelligence-gathering efforts. Although the media is regulated, an incredible amount of discussion is going on in the Chinese media. Because of the language barrier many American businesspeople did not have easy access to this information, which in some cases was critical to their operations. The probability of China's entry into the WTO increased their appetite for timely and accurate information upon which to make decisions, and our readership grew accordingly.

Secondly, at the same time, the Chinese media world was growing, they lost their government subsidies, and restrictions of all kind were easing. We have found the Chinese media increasingly willing to share their information with us. In fact, we recently completed an agreement with Caijing Magazine, founded in 1998 and a pioneer in investigative reporting about China's securities markets, which allows us to publish their market-moving information in English on chinaonline.com the same day it is published in China. Things are changing.

The third piece of the puzzle for us was technology—the Internet. Whereas before, we could not have gathered Chinese media information, and distributed it cheaply around the world, the Internet allowed us to do that.

After twenty-two years of working with media in China, my conclusions and observations to share with you:

Of the top ten media companies in the world, by the year 2010, two will be Chinese. This is simply a matter of looking at projected demographics and adspend per capita. Foreign media companies will be restricted until the Chinese companies are ready to compete.

All media is biased, and sophisticated readers around the world want more than one perspective.

Technology has opened new horizons for both the Chinese media, and for outsiders interested in China. Our company is an example of these new opportunities.

Media around the world is primarily funded by advertising. Whereas in most of the world there is a recession in advertising, China's advertising spending is still growing at a rate to match her GDP growth—in the range of 6–7%. This in turn will fuel continued growth in television and print, particularly magazine titles.

Content might be king, but Chinese-language content will be Emperor. There is a significant opportunity for the U.S. entertainment and education industries, if they can overcome the barriers of lack of intellectual property protection, and localization into Chinese. Both will require new business models (SONY) and also investment in translation and other services.

The Internet will grow exponentially in China in 2002. Broadband and wireless penetration will be key. You have all seen the Accenture posters at airports that claim that the Internet will soon be dominated by the Chinese language. That prediction originally came from China Online. However, the technological configuration will be different than the U.S. Instead of the model created in the U.S., a PC attached to a phone line of some sort, in China, you will see widespread penetration through cell phones and broadband television. China is pulling ahead in the broadband race. Paradoxically, China has benefited from a period of slow deregulation, versus what I would call hyper-deregulation in the U.S., which led to too many teleco entrants chasing after too few customers with too much poorly allocated capital.

Public policy issues that go beyond infrastructure are key determinants of differential development of the Internet, and policy in China is basically beneficial. Local access charges are competitive, and there is no taxation on Internet sales—both of which helped the U.S. develop e-commerce on the Web.

My recommendations for the Committee are the same as the recent Task Force Report sponsored by the Council on Foreign Relations. In particular, I think that industry-specific public-private partnerships would be the most effective. As stated in the Task Force Report:

> Develop a congressional-private sector partnership to ensure active oversight of China's WTO compliance in ways that ultimately strengthen Sino-American Relations. (*Beginning the Journey—China, The United States and the WTO*)

Although the direct effect of WTO on the media industry is likely to be small, deregulation as described under WTO can be a base for liberalization of the media industry in China. However, private market forces, lured by China's promise as an advertising based media market are likely to be more influential than regulation-based measures, since the regulatory environment in China is still evolving based upon changing technologies not foreseen by its lawmakers and policy decision makers. Finally, China's currently fragmented industry is likely to wake up to the challenge of foreign media companies, so that even in a completely deregulated environment, completion is likely to be fierce, and cultural issues related to content might be difficult for foreign entrants to overcome.

Respectfully submitted.

Chairman D'AMATO. Thank you very much.

Next, we have Mr. Hurst Lin, SINA.com General Manager.

I hope he is not angry with us for having stolen some of his staff, who is now sitting behind us on the dais on this Commission; but we share some of his protégés, I guess, here.

Please go ahead.

STATEMENT OF HURST LIN, VICE PRESIDENT, BUSINESS MANAGEMENT AND GENERAL MANAGER, NORTH AMERICA, SINA.COM

Mr. LIN. Thank you, Mr. Chairman, and good afternoon, Commissioners, and ladies and gentlemen.

Actually, I had originally thought this was going to be a panel on high-technology, and I prepared my written testimony about high-technology, but now it looks like it is more on media, so I'll change all of the things that I was going to talk about and just focus on a few key points about the media, particularly leading from what Lyric was saying.

My name is Hurst Lin, and I am the General Manager of SINA U.S. operations and a cofounder of the company. The few key points that I want to talk about regarding the internet are that—well, first, let me give you a little bit of introduction about SINA.com.

SINA.com is by most counts the largest Chinese website in the world. We have about 30 million registered users. That would probably make us, if it were a periodical or a newspaper, one of the largest newspapers in the world. Folks from all across China, Taiwan, Hong Kong log onto our site to read the latest news, to get the latest information, and so on.

What makes internet and SINA different from the other publications is that we have the interactive nature, which the other traditional media companies don't have. People can respond to the articles, people can respond to the current topics, right on our site.

We have a very popular bulletin board where many Western journalists actually go to try to get a feel for what the Chinese folks are thinking about at any given time and on any given subject.

With that, as far as the Chinese Government's attitude toward SINA.com, I would say that it is definitely much, much better than what people would normally assume the government would do, the reason being that there have been many instances where, for example, in recent days, there have been postings about corruption on our site, and the government actually got behind it and looked into it. I think one of the things that had been talked about in the Western press was the firecracker manufacturing in schoolhouses. That was first mentioned on the SINA.com website, on our bulletin board. And rather than going ahead and shutting down comments such as this, the government actually looked into that, which eventually led to the prosecution of some of the perpetrators and to the banning of such practices in rural China. There have been many, many different issues such as this.

Interactivity is a two-edged sword, and the government knows that as well, because folks are going to get online and say whatever they want to say. But they do realize that the folks on the internet in China tend to be the more educated, younger, more professional and more educated folks vis-a-vis the folks on the street, the reason being that computers are still expensive relative to the average per capita income in China, and although the cost of getting on the net is getting lower and lower, still, most of the folks on the internet right now, particularly those 20 or 30 million people, really represent the very tip of Chinese society, and they really do care about how these people perceive their government.

So there are cases—for example, one incident that happened recently was the downing of the U.S. spy plane. I think that was an incident where the government did not intend to make as big a deal out of it, yet the people on the street—or you could say the young folks on the internet, actually—made a much bigger deal out of it than the government wanted to. So that was an incident where you can see how the government, at the same time trying to respond to popular sentiment which at the time was that they felt invaded—I think the folks in China felt that if there is a peeping Tom looking from the street into my back yard, looking into my bedroom at what I am doing, then, why don't I have any right at all to shoot it down, or arrest these people—and I think the government eventually really tried to take care of these concerns while at the same time really trying to defuse a diplomatic crisis that they didn't really want to have in the first place.

That brings me to the fact of the impact of the WTO. I do disagree with Mr. Uren and also with Lyric's assertion that WTO does not have an impact on our particular industry. I think it does, because with China's entry into WTO, the first thing, at least in our example, is that they have relaxed quite a bit of the legal climate for new media industry and for high-tech industry in China. Back in 1999, it was tremendously difficult for companies like ours to be able to have foreign investments, to be able to have funding from overseas, because they were concerned, again, about foreigners taking control of a very vital and important piece of their culture or industry. But with the WTO and the negotiations within the WTO, they informally—they did not formally relax the rule, but they did informally relax the rule, and that finally culminated in SINA being able to have an initial public offering on the NASDAQ Exchange.

I will conclude my remarks by saying that WTO helps not only the media industry and the internet industry, but it also helps high-tech industry. And I would say that if the U.S. Government can formulate a correct trading policy as well as a WTO policy toward China, it would go a long way in helping to open up China's markets to foreign investors and foreign competitors.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF HURST LIN

Good morning, Commissioners, ladies and gentlemen, my name is Hurst Lin. I am the General Manager of SINA U.S. operations and a co-founder of the company. I am honored to be invited here today to make a few comments regarding the impacts of China's accession to WTO on our company and our industry.

In my view, China's accession to WTO will be regarded as a historical milestone in both China's and the World's economic development as this event formally integrates the world's largest nation into the economy of the world. With one sixth of the world's population and a dynamic economic growth, China is well on its way to become a global economic engine that will help drive the world economy.

However, this is not to say that there will not be some potentially serious issues or obstacles along the way to integrating China into the world economy. For instance, for the U.S., the already large trade deficit with China may continue to grow. For China, the onslaught of foreign competition against its inefficient state-run enterprises could swell the ranks of unemployed thereby leading to potential political instabilities. Both of these developments if not managed properly may lead to increasing frictions between the two nations to the detriments of the consumer, business and national security interests of both nations.

Given that numerous works and studies have already been done on the macro economic impacts of the above issues, I will restrict my comments only to the particular impacts on SINA and the industry we operate in—i.e. the Internet industry.

On this count, it is our view that China's entry into WTO has proven to be very beneficial for SINA and our industry as a whole. In particular, China Government has made great strides toward making the operating environment for SINA and our peers in China much more hospitable than ever before.

Now allow me to go into greater details:

The first positive impact that we felt from China's accession to WTO was a large change in the investment and legal climates for foreign investors in our industry. Prior to WTO, China had a rather defensive economic policy. Indeed many industries were off limit to foreign investments. The Internet industry was one such industry. In 1999, our company with U.S. venture funding was looking to establish a presence in the rapidly growing Internet market in China. With WTO still more than two years away, we had to construct various joint ventures and complex corporate holding structures to enter this market. These various awkward setups contributed to very high expenses and also added a layer of unnecessary corporate complexities and investment uncertainties for our shareholders. Fortunately, as China's negotiation with both the U.S. and EU drew closer to successful conclusions in late 2000, the China Government began to informally relax its restrictions step by step. Subsequently, not only was SINA able to operate successfully in China, we were able to receive permissions from the Government to make an initial public offering on the U.S. stock exchange in 2000. Today, the investment climate is even brighter with China as an official member of the WTO. The China Government has reversed its prior defensive policy and embraced a very aggressive schedule to open up more Internet and high tech related industries for foreign ownership and investments. Consequently, our company will be able to take advantage of these policy changes to expand into new areas to further the growth of our business.

The second positive impact is the opening of the rapidly growing high technology market in China to foreign firms. This was accomplished through the relaxation of investment rules as I mentioned above and the lowering of tariff and non-tariff barriers to imports. As more high technology companies increase their export into or establish manufacturing in China, our company has seen a dramatic decrease in the costs of our high tech equipment purchase. This has helped our company to increase sales and decrease costs in China. Furthermore, as our business in China expands we have increased our equipment purchases from our suppliers, many of who are American firms. This, in turn, has assisted these firms to gain a foothold in the emerging China Internet market. Indeed, in the time leading up to China's entry into WTO and thereafter, we have not only seen our suppliers prospered, we have also seen our business partners prospered as well. For instance, in early year 2000, we assisted Dell Computer in setting up an Internet marketing campaign in China to sell PC to the burgeoning Internet user population. Over the course of two short years, Dell Computer has risen from a minuscule market position in China to become the number one foreign brand PC maker. This is a tremendous achievement for Dell, in light of the fact that China is now the second largest PC market in the world after the U.S. Naturally, as we contributed to Dell's success in China, Dell, in turn, has rewarded SINA generously through their strong support of our business. We see this mutual support between SINA and its suppliers and business partners as part of a virtuous circle in our industry. Indeed, we believe that as time passes, there will be an increasing critical mass of American businesses operating in China who can leverage the local talent pools and their market know-how to support one another to produce high quality products for sales both in China and on the international markets. As a matter of fact, the Chinese governments both on the national and local levels are investing heavily in building and marketing economic zones with excellent infrastructures to attract such concentration of foreign businesses.

The third positive impact is the increasing ability for U.S. firms to tap the great human capital in China. China has many great universities that produce excellent knowledge workers. Prior to the opening of China, only a small fraction of these talents were being utilized through their emigration to places such as the U.S. and Europe. Today, companies are utilizing these talents directly inside China to produce goods and services for domestic consumption and export. Take SINA for instance, we have been able to rely on our Chinese staff to produce the bulk of our Internet programming at a fraction of the costs incurred by many of our competitors. Through the World Wide Web we offer these programming to our users worldwide from Asia to America and to Europe. Thus by utilizing Chinese talents, we achieve the goal of offering high quality products with minimum costs to our customers and along the way maximize the returns to our U.S. shareholders.

Lastly, with China's accession to WTO, in time, many Chinese firms will undoubtedly become world-class in scale much as many Japanese and European companies did in the 1960's and 70's. When such time comes, these companies will inevitably follow the footsteps of their European and Japanese predecessors in making large investments in the U.S. They will do so to be close to the U.S. market and in the process help to recycle a good portion of the trade surpluses that China accumulated over the years. In fact, a few of our largest domestic Chinese business partners, such as Legend Computer and Haier Appliance have already begun to explore making investments in the U.S.

In summary, I would reiterate that China's accession to WTO marks an important milestone in the world's economic development. By formulating appropriate foreign and economic policies toward China, the U.S. can go a long way to help China make a smooth transition to an open market economy and ensure the well being and prosperity of one sixth of the world's population.

This concludes my formal remarks. Thank you.

Chairman D'AMATO. Thank you very much, Mr. Lin.

We'll move now to Mr. Stephen Hsu, CEO of SafeWeb—and an Oregonian.

STATEMENT OF STEPHEN HSU, CHIEF EXECUTIVE OFFICER, SAFEWEB, INCORPORATED

Mr. HSU. That's right—from the University of Oregon.

You may have noticed a moment ago that I spilled some water on my laptop.

Chairman D'AMATO. Did it ruin your testimony?

Mr. HSU. It did. Actually, my laptop is completely crashed.

Chairman D'AMATO. Do you want us to give you a copy of your testimony? We have your testimony right here.

Mr. HSU. That's fine. Yes, that would be great, actually. I started scribbling extemporaneous notes, but I would actually rather follow what I wanted to say.

Thank you.

Mr. Chairman and members of the Commission, thank you for this opportunity to share my views on this important subject.

Vice Chairman LEDEEN. Mr. Hsu, could we encourage you not to read? Just wing it.

Mr. HSU. Sure. Mine is pretty short.

First, a little bit about my background. As mentioned, I am an Oregonian. I am a professor of theoretical physics at the University of Oregon.

A few years ago, I founded an internet privacy and security company called SafeWeb, along with some former Ph.D. students.

SafeWeb develops leading-edge security and encryption software. It is used by corporations, by government agencies, and also by individuals to protect their data as it moves over the internet.

SafeWeb is backed by several venture capital funds, including In-Q-Tel, which is the CIA venture fund. In 2001, our servers secured over 1.5 billion web transactions, with 128-bit encryption. One of our software products which we call "Triangle Boy" is deployed in a worldwide network currently used by tens of thousands of people, particularly in the PRC, to evade local government censorship of web activity. This network is supported in part through a small pilot project with the U.S. Voice of America.

Next month, SafeWeb will launch a new product called the Secure Extranet Appliance, which enables secure remote access by employees and partners via any web browser. This is mainly aimed at the U.S. enterprise market.

Let me just make a few comments about how I view China's future economic and technological potential.

China is already a strong competitor in low to medium value-added industries ranging from textiles to light manufacturing and low-end electronics. However, I think many people will be surprised at the speed with which China develops capabilities in high-tech areas such as semiconductors, advanced networking and telecommunications equipment, computer components, and perhaps even software development.

An abundance of aggressive and well-educated Chinese engineers and entrepreneurs are in place to benefit from knowledge transfer and capital flows from abroad.

Technology and capital will come not only from America, Europe, and Japan, but perhaps surprisingly, from China's own "renegade province," Taiwan. Taiwanese companies, which account for 60 percent of world laptop production, 79 percent of world motherboard production, and are the second-largest buyers of semiconductor manufacturing equipment—after only the United States but ahead of Japan—have already begun investing in production and even R and D capacity in China.

Over 300,000 Taiwanese entrepreneurs are living in Shanghai alone, and several multi-billion-dollar chip fabrication plants are already under construction there. WTO will only hasten these trends as it lends clarity and predictability to the business environment.

However, as China transforms itself into a formidable economic competitor, it will itself face tremendous internal challenges. With its accession to WTO, China's inefficient state-owned enterprises will come under enormous pressure. Inevitable large-scale restructuring will lead to unemployment and loss of social benefits for many workers.

The state is well aware of this and will presumably choose its battles carefully in protecting certain industries as much as possible.

However, there will be many losers in the reorganization of China's economy, particularly among peasants and among older workers. Among the former group, there are already millions of migrant workers living illegally in cities like Beijing, where they are relegated to the lowest forms of labor.

The likely result of this misery and inequality is widespread social unrest, which the government will undoubtedly act brutally to suppress. Many experts estimate that China must maintain economic growth rates of roughly 7 to 8 percent just to keep unemployment and other social problems within tolerable bounds. An extended period of lower economic growth could lead to social instability and perhaps even the collapse of the current government.

Let me now turn to the impact of the information revolution on this complex situation. Currently in China, as mentioned, there are approximately 140 million mobile phone users, more than in the United States currently. While this only amounts to 10 percent of the population, we can expect that within a few years, a much larger fraction, perhaps 30 percent, of the population will have mobile phones.

Currently, about 30 million Chinese use the internet. This number is also increasingly rapidly. Until recently, it was doubling every year, and now it appears to double every 2 years.

So I would say that roughly within 5 years at most and perhaps 3 years, a critical mass of people in China will have access to the internet—say, 30 percent. Some of these people will access the internet via fixed line, some will access via 3G technology, which means over their mobile phone. But inevitably, a very large segment of the population will have that access.

So what are the implications of this? An optimist would argue that the internet and telecommunication in general enable individual freedom of expression and freedom of information. Both are obviously crucial underpinnings of democracy and the rule of law. They are in short supply in China, and one might argue that they are crucial to China's continued economic as well as political development.

While there is no denying that the internet generally enables free expression and communication, a careful analysis reveals that governments can indeed exert substantial control over the medium. For a domestic example, one might simply ask Napster whether the internet is beyond government control.

Local internet service providers not only in China but in the United States can easily log the behavior of individual users, such as what they access and what information they view. These logs are available to state security forces and are easy to search using commodity software and hardware. In China, the Ministry of Information Industry and the State Council Information Office have now deployed the infrastructure to block access to offending websites and web resources, even those which are hosted outside of China. Well-known examples of blocked sites are those of CNN, the New York Times, and Voice of America. But the sites that the Chinese Government would most like to block are Chinese language sites such as ChineseNewsnet.com, which provide translated international news stories and a forum for their discussion.

The example of the school explosion in Jianxi province, which Hurst mentioned, provides an interesting example of the future promise and current limitations of the internet in China. In March of 2001, chat rooms were closed down following the posting of comments accusing the government of covering up an explosion in a school in rural Jianxi. The Western press, alerted by the chat room information, reported that primary school children had been forced to make firecrackers in order to subsidize the school's income.

In contrast, Premier Zhu Rongji claimed that a suicide bomber set off the explosion. Villagers contradicted Zhu and the official media as well in chat rooms and on bulletin boards. Criticism focused both on the level of spending on education and the government's handling of the tragedy. Eventually, the government retracted the original story, and Zhu came as close to a public apology as any politician has in recent Chinese history.

This example makes clear the power of a free internet in the hands of concerned citizens and the quandary faced by any totalitarian state that craves the economic and technological benefits of the internet while fearing its democratic potential. One can only imagine the problems that the Chinese Government will face when 30 to 50 percent of the population has internet access.

Yet technology is a two-edged sword. In the future, the government may also have the capability to track down any individuals who post critical comments and punish them, thereby stifling dissent.

One important technological consideration in these discussions is the widespread availability of encryption technology. Every modern web browser has the capability to encrypt data using ciphers so powerful that even national intelligence agencies cannot decrypt the content. These capabilities were included in browsers to enhance E-commerce capabilities, and this was over the objections of U.S. intelligence services.

Our company's product, Triangle Boy, exploits the encryption capability of browsers and creates a distributed network which allows individual users in China to access the entire web through an unbreakable encrypted channel. Currently, it is used approximately 100,000 times per day by Chinese users despite vigorous efforts of the Chinese Government to hunt down and block access to the network.

As a small venture-backed company, SafeWeb does not have the resources to further develop this network since it does not generate revenues. However, we are eager to see the technology in the hands of a stable entity such as the U.S. Government. The cost of further developing and deploying this technology can be measured in the millions of dollars, but I believe this is a small cost compared to the possible benefits.

For a price far less than the cost of a single fighter jet, the U.S. can ensure that in the event of a future spy plane incident or diplomatic impasse, the Chinese people will have access to more than just the official Government point of view.

Thanks for this opportunity.

[The statement follows:]

PREPARED STATEMENT OF STEPHEN HSU

Mr. Chairman and members of the Subcommittee, thank you for this opportunity to share my views on this important subject. Before beginning my remarks, let me briefly introduce myself. I am currently a professor of theoretical physics at the University of Oregon. In 2000, I co-founded an Internet privacy and security company called SafeWeb, Inc. SafeWeb develops leading-edge security and encryption software that is used by corporations, government agencies and individuals to protect important information in transit over the Internet.

SafeWeb is backed by several venture capital funds, including In-Q-Tel ( ), the CIA venture fund. In 2001 our servers secured over 1.5 billion Web transactions with 128-bit encryption. One of our software products, called "Triangle Boy" is deployed in a worldwide network used by tens of thousands of people, particularly in the PRC, to evade local government censorship of Web activity. This network is supported in part through a pilot project with the U.S. Voice of America. Next month, SafeWeb will launch a new product, called the Secure Extranet Appliance (SEA), which enables secure remote network access by employees and partners via any Web browser. I believe it will find broad deployment by private companies as well as government agencies.

Let me begin my testimony with some comments on China's future economic and technological potential. China is already a strong competitor in low to medium value added industries ranging from textiles to light manufacturing and low-end electronics. However, many will be surprised at the speed with which China develops capabilities in areas such as semiconductors, advanced networking and telecommunications equipment, computer components and perhaps even software development. An abundance of aggressive and well-educated Chinese engineers and entrepreneurs are in place to benefit from knowledge transfer and capital flows from abroad. Technology and capital will come not only from America, Europe and Japan, but from China's own "renegade province," Taiwan. Taiwanese companies, which account for 60% of world laptop production, 79% of world motherboard production, and are the second largest buyers of semiconductor manufacturing equipment (after the United States, but ahead of Japan), have already begun investing in production and even R&D capacity in China. Over 300,000 Taiwanese entrepreneurs are living in Shanghai alone, and several multi-billion dollar chip fabrication plants are already under construction there. WTO will only hasten these trends, as it lends clarity and predictability to the business environment.

However, as China transforms itself into a formidable world economic competitor, it will itself face tremendous internal challenges. With its ascension to WTO, China's inefficient state-owned enterprises (SOEs) will come under enormous pressure. Inevitable large scale restructuring will lead to unemployment and loss of social benefits for many workers. The state is well aware of this, and will presumably choose its battles carefully in protecting certain industries as much as possible. However, there will be many losers in the reorganization of China's economy, particularly among peasants and among older workers. Among the former group, there are already millions of migrant workers living illegally in cities like Beijing, where they are relegated to the lowest forms of labor. The likely result of this misery and inequality is widespread social unrest, which the government will undoubtedly act brutally to suppress. Many experts estimate that China must maintain economic growth rates of roughly 7–8% just to keep unemployment and other social problems within tolerable bounds. An extended period of lower economic growth could lead to social instability, and perhaps even the collapse of the current government.

Let me now turn to the impact of the information revolution on this complex and rapidly changing country. Currently in China there are approximately 120 million mobile phone users—more than in the U.S.! While this only amounts to 10% of the population, we can expect that within 5 years a much larger fraction, perhaps a third, will have mobile phones. Currently, about 30 million Chinese use the Internet. This number is also increasing rapidly, perhaps doubling on a yearly timescale. Within 5 years so-called 3G (third generation) wireless technologies will be in place, which allow Internet access over a mobile phone. Therefore, between fixed-line and wireless access, it is very likely that within five years a critical mass—perhaps 30–50% of the Chinese population, comparable to the current U.S. fraction—will have some form of Internet access! Five years is quite a short time, and I think it is very important that we think through the implications and prepare for this eventuality now.

What are the implications of widespread Internet access? An optimist would argue that the Internet (and telecommunications in general) enables individual freedom of expression and freedom of information. Both of these freedoms are crucial underpinnings of democracy and the rule of law. They are in short supply today in China, and one might argue that they are crucial to China's continued economic, social and political development.

While there is no denying that the Internet generally enables free expression and communication, a careful analysis reveals that governments can indeed exert substantial control over the medium. (For a domestic example, one might ask the founders of Napster whether the Internet is beyond government control.) Local Internet Service Providers (ISPs), in the U.S. as well as in China, can easily log the behavior of individual users, such as what sites they access and what information they download. These logs are available to state security forces and are easy to search using simple software running on inexpensive hardware. In China, the Ministry of Information Industry (MII) and State Council Information Office (SCIO) have now deployed the infrastructure to block access to offending Web sites which are hosted outside of China. Well-known examples of blocked sites are those of CNN, The New York Times and VOA, but the sites that the Chinese government are most concerned about are Chinese language sites such as ChineseNewsnet.com, which provide translated international news stories.

The example of the school explosion in Jianxi province provides an interesting example of the future promise and current limitations of the Internet in China. In March 2001 chat rooms were closed down following the posting of comments accusing the government of covering up an explosion in a school in Jianxi province. The Western press, alerted by the chat room information, reported that primary school children were forced to make firecrackers in order to subsidize the school's income. In contrast, Premier Zhu Rongji claimed that a suicide bomber set off the explosion. Villagers contradicted Zhu and the official media in chat rooms and on bulletin boards. Criticism focused on the level of spending on education and the government's handling of the tragedy. Eventually, the government retracted the original story and Zhu came as close to a public apology as any politician in recent Chinese history.

This example makes clear the power of a free Internet in the hands of concerned citizens, and the quandary faced by any totalitarian state that craves the economic and technological benefits of the Internet while fearing its democratic potential. One can only imagine the problems that the Chinese government will face when 30–50% of the population has Internet access. Yet, in the future the government may have the capability to track down individuals who post critical comments and punish them, thereby stifling dissent.

One important technological consideration in this discussion is the widespread availability of encryption technology. Every modern Web browser has the capability to encrypt data with ciphers sufficiently powerful that even national intelligence agencies cannot decrypt the content. These capabilities were included in browsers to enhance e-commerce capabilities, over the objections of U.S. intelligence services. SafeWeb's Triangle Boy software exploits the encryption capability of browsers and creates a distributed network which allows individual users in China to access the entire Web through an unbreakable encrypted channel. Currently, it is used approximately 100,000 times per day despite vigorous efforts on the part of Chinese security forces to hunt down and block access to the network. As a small venture-backed company, SafeWeb does not have the resources to further develop this network, since it does not generate revenues. However, we are eager to see the technology in the hands of a stable entity such as the U.S. government. The cost of further developing and deploying this technology can be measured in millions of dollars, but I believe that this is a small cost compared to the possible benefits.

For a price far less than the cost of a single fighter jet, the U.S. can ensure that in the event of a future spy plane incident or diplomatic impasse, the Chinese people will have access to more than just the official government version of the events.

Thank you, Mr. Chairman, for this opportunity to speak.

Vice Chairman LEDEEN. That was very interesting testimony. Thank you very much, Mr. Hsu.

Ms. Sherman?

STATEMENT OF LAURA B. SHERMAN, COMMUNICATIONS COUNSEL, PAUL, WEISS, RIFKIND, WHARTON & GARRISON

Ms. SHERMAN. Thank you.

I hate the notion that I have to go last; you guys have been sitting here since 8 o'clock this morning.

Vice Chairman LEDEEN. You are not last, believe me.

Ms. SHERMAN. I submitted testimony. I will summarize it in short order and leave it to the questions so you can get to the things you are really interested in.

The area that I know a lot about is telecom. I was at the U.S. Trade Rep's Office from 1992 to 1997, and while I was there, I was the lawyer for the negotiating team for the World Trade Organization's Basic Telecom Agreement. I helped write the reference paper which set out a variety of regulatory principles; I also helped get market access and commitments from various countries. I have spent a lot of time following the negotiations of China's WTO commitments in the telecom and information sector. I can say with all honesty that their commitments are pretty lousy; they are implemented on a staged basis, both in terms of the amount of foreign investment that is permitted and in the geographic regions in which you are permitted to invest.

In the mobile and wire line services, foreign investors will never be able to own more than 49 percent. In the value-added context, they will be able to own 50 percent. That will be the maximum.

Nonetheless, I think you will see that there is going to be a fair amount of foreign investment. More importantly, I think that what the Chinese have used the WTO accession process to put their laws—I was going to say to put their laws in order, but they never had any—it is to adopt the laws and to make clearer the rules and regulations applying to the telecom sector.

So over the course of the past 2 years, China has adopted telecom regulations which discourage anticompetitive activities by telecom service providers. The telecom regulations contain rules on interconnection—in other words, how does one telephone provider use the network of another provider.

The Telecom regulations also describe licensing requirements, setting out criteria for who can and cannot get a license. In December, the State Council finally came out with the foreign investment rules.

Through this process, on routing and issuing regulations the PRC has made it clearer to foreign investors, and the domestic industry as to how you can enter the market to provide telecom and information services. That clarity, or the beginnings of clarity, the beginnings of transparency, will go a long way in helping the telecom and the information sector develop.

I'll just leave it at that and let you ask questions.

[The statement follows:]

Prepared Statement of Laura B. Sherman

TELECOMMUNICATIONS SERVICES IN CHINA: NOT YET WILDLY ENTHUSIASTIC

I would like to thank the members of the Commission for inviting me to testify on China's ability to comply with its World Trade Organization (WTO) commitments. With the help of my colleagues in the Paul Weiss offices in Hong Kong and Beijing, I have closely followed the lengthy negotiations which finally culminated in China becoming the 143rd member of the WTO. I have taken a particular interest in China's commitments in the telecommunications sector because I was part of the U.S. Government team that negotiated what is called the WTO's 1997 Basic Telecommunications Agreement. When we concluded those negotiations, industry proclaimed itself "wildly enthusiastic."

I have not heard anyone in industry say they are "wildly enthusiastic" about China's commitments in the telecommunications and information services sector. Those commitments fall woefully short of full market access. In addition, the Chinese government has made it clear that it intends to "manage" competition.

Recently, the government announced its decision to split China Telecom into totally separate northern and southern companies, creating six state-owned enterprises to provide basic telecommunications services. This restructuring will continue over the next two years until the market is consolidated into four comprehensive operators.

The desire to manage development of the telecommunications and information sectors is also evident in the creation in Fall 2001 of the State Council Information Commission. This Commission, headed by Premier Zhu Rongji, includes two other influential members of the Politburo Standing Committee, Vice President Hu Jintao, who is rumored to be the successor to Jiang Zemin, and Vice Premier Li Lanqing and two other very influential members of the Politburo, Ding Guangen, the head of the Propaganda Department of the Chinese Communist Party, and Vice Premier Wu Bangguo. It replaces the Ministry of Information Industries as the policy-making body, leaving open the question of what MII's role will be going forward. The creation of the Commission signifies the extreme importance placed by the Chinese government on this industry sector.

While there is no basis for "wild enthusiasm," there are market opportunities. As I will describe below, the WTO commitments and the implementing regulations go a long way towards clarifying and formalizing the rules for foreign service providers, promoting competition and providing certainty. There remain numerous gray areas and implementation issues. In the long term, however, the introduction of pro-competitive regulation will lead to a more rational Chinese market for telecommunications and information services, to greater opportunities for foreign service suppliers and to better service for Chinese consumers.

CHINA'S WTO COMMITMENTS

China has undertaken specific commitments with respect to value-added services and basic telecommunications services, which vary by type of service and geographic region and are phased in over time. There are no restrictions on the ownership interest that can be held by any one foreign entity, other than the total limits listed below, and no limits listed for the number of licenses to be issued. China has not restricted the technological means through which the specified services can be provided (e.g. cable, satellite). Services can be provided through facilities that are owned or leased; China's WTO schedule contains no limitations on the types of resale that may be employed.

The following chart sets forth China's commitments in the telecommunications sector.

Type of Service	Percentage of Foreign Investment Permitted					
	As of 12/11/01	As of 12/11/02	As of 12/11/03	As of 12/11/04	As of 12/11/06	As of 12/11/07
Value Added Services	30% in Beijing, Shanghai and Guangzhou	49% in 17 cities	50% with no geographic restrictions	No Change	No Change	No Change
Basic Telecoms Services—Mobile	25% in Beijing, Shanghai and Guangzhou	35% in 17 cities	No Change	49% in 17 cities	49% with no geographic restrictions	No Change
Basic Telecoms Services—Fixed.	0%	0%	0%	25% in Beijing, Shanghai and Guangzhou	35% in 17 cities	49% with no geographic restrictions

China also agreed to "additional commitments" relating to the regulation of telecommunications services. These regulatory principles were adopted by most of the WTO Members who participated in the WTO's 1997 Agreement on Basic Telecommunications and are embodied in something called the "Reference Paper."

The Reference Paper imposes obligations in a number of different areas deemed essential to promote competition in formerly monopolistic markets. China must take measures to prevent "major" suppliers of telecommunications services from engaging in or continuing anti-competitive practices. It must adopt rules requiring "major" suppliers to provide interconnection to competitors on a non-discriminatory basis and at rates that are cost-oriented. Interconnection must be provided at any technically feasible point in the network and the elements must be unbundled so that a service provider need not pay for network components or facilities that it does not require for the services to be provided.

Other obligations include ensuring that a major supplier does not provide its subsidiaries or affiliates better treatment than it gives other suppliers. Interconnection procedures and rates must be made publicly available so that a major supplier cannot negotiate wildly different interconnection agreements with new entrants. Moreover, there must be a mechanism for timely resolution of interconnection disputes by an independent domestic body. In addition, there are requirements relating to transparency and licensing.

Finally, China has agreed that it would have a regulator that is separate from, and not accountable to, any operator. MII can continue to act as the regulator so long as it does not control China Telecom or the other state-owned telecommunications companies. But the regulator must be impartial with respect to all market participants. This specifically imposes a requirement not to favor the state-owned companies.

INTERNET SERVICES

Although not specifically listed in its WTO schedule of commitments, the Chinese promised certain treatment of Internet services during the bilateral accession negotiations with the United States. The Chinese agree to provide market access and national treatment to foreign Internet Content Providers ("ICPs"), which provide content for the web sites, and foreign Internet Service Providers ("ISPs"), which provide access to the web sites. The commitments relating to ICPs are the same as those for value-added services, set forth above, that is, 30% foreign ownership now for ventures in Shanghai, Guangzhou and Beijing, rising to 50% with no geographic limitations in December 2003. ISPs, in contrast, are treated as if they were fixed wireline services. As a result, implementation of market access will be spread over six years and foreign investment will be limited to 49%.

THE REGULATORY FRAMEWORK

China began a number of years ago to institute a regulatory framework for the telecommunications and information services sectors. From September 2000 until spring 2001, China issued The Telecommunications Regulations of the People's Republic of China ("Telecom Regulations"), Measures for the Administration of Internet Information Services, Regulations for the Administration of Internet Electronic Notice and Interim Measures for the Administration of Posting News on Websites.

Since then the Ministry of Information has issued a Revised Catalogue of Classes of Telecommunications Businesses and, most importantly, from the WTO perspective, the long-awaited regulations governing foreign investment—Provisions on the Administration of Foreign-Invested Telecommunications Enterprises ("Foreign Investment Regulations").

I would like to briefly review the Telecom Regulations and the Foreign Investment Regulations in light of China's WTO commitments and then describe the remaining gray areas and issues of concern for full WTO implementation.

Telecom Regulations

These regulations formalize the MII as the country's regulator, authorized to issue licenses and adopt regulations. Consistent with its WTO obligations, Article 4 of the Regulations states that the regulator will "promote development, openness, fairness and impartiality." Whether MII can truly distance itself from China Telecom and the other state-owned carriers and act transparently and impartially remains to be seen.

The Regulations (as modified by the Revised Catalogue of Telecom Businesses) define telecommunications services as either "basic" or "value-added." Attachment 1 sets out a breakdown of the services, which generally correspond to the WTO categories. The list provides some certainty but, unfortunately, includes many overlapping businesses and is confusing in terms of whether certain services are basic or VAS. It does make clear, however that a number of services which are categorized as "basic" will be regulated as "value-added." This could be important because value-added services, as noted above, are subject to the more favorable foreign investment and geographic WTO commitments. It is not clear, however, that services categorized as value-added services for purposes of the Telecom Regulations will be treated as value-added services for foreign investment purposes.

Having defined the various types of services, the Telecom Regulations focus mainly on competition safeguards and interconnection for wireline services, both key components of China's WTO commitments. Many of the concepts in the Reference Paper have been adopted. The Telecom Regulations prohibit any telecommunications service provider from engaging in anti-competitive activities, such as providing below-cost services, granting unreasonable cross subsidies, and engaging in activities, which constitute unfair competition.

The Telecom Regulations impose interconnection obligations on "dominant carriers," tracking the Reference Paper definition of a "major supplier" closely. Dominant carriers have to provide interconnection to competitors at points where it is technologically feasible and economically rational. Interconnection must take place within a set timetable, with no unreasonable delays and on a transparent and nondiscriminatory basis. Dominant carriers must publish a set of rules that include timing and provide unbundled network elements. As required by the Reference Paper, the Regulations establish a dispute settlement mechanism in the event the carriers cannot agree on interconnection. Thus in the area of competition safeguards and interconnection, at least on paper, the PRC appears on track to implement its WTO commitments.

Licensing requirements for basic services providers are another story. While some of the licensing provisions are consistent with the WTO obligations, others do not appear to be. On the "plus" side, the Regulations require (i) MII to give reasons for denying an application for both basic and value-added licenses and (ii) the relevant licensing authority must make a decision within 60 days of receipt of an application for a value-added services license and 180 days for a basic services license.

The criteria for obtaining a license, however, are problematic. In order to get a basic services license, a company must be a "sole purpose entity," which does not provide other services. It is not clear whether this requirement can be satisfied by establishing a sole-purpose subsidiary to carry on the telecommunications business, while its parent undertakes other services. More disturbing, however, is the requirement that at least 51% of the equity of the licensee must be owned by a state-owned enterprise. This limitation appears to be inconsistent with China's commitments and severely limits the number of potential joint venture partners.

Another provision of the Regulations that appears to be inconsistent with China's WTO commitments is the requirement that all international telecommunications traffic must past through a single "international gateway bureau" established and approved by MII. This provision is a limitation on the way foreign investors can provide service and the type of service provided. When China's commitments on international services come into force in 2004, this provision will severely limit the ability of foreign investors to provide international telecommunications services.

The Regulations prohibit transmission of broad categories of information: (i) material which opposes the basic principles of the PRC Constitution, (ii) material which jeopardizes national security or national unity, (iii) material which disseminates rumors, disrupts the social order or damages social stability and (iv) material which damages State religious policies or advocates sects or feudal superstitions. The Regulations require the service provider to stop transmitting the illegal information if it learns of it, preserve relevant records and report the transmission to the relevant authorities. While a WTO member is allowed to take actions inconsistent with its obligations if "necessary for the protection of its essential security interests," this part of the Telecom Regulations creates extreme uncertainty for service providers. It is a potential trap for foreign investors since it is not clear what kind of information is prohibited and the practical means by which such transmissions can be stopped or preserved (other than through wiretaps).

Foreign Investment Regulations

The Foreign Investment Regulations, a translation of which is included as Attachment 2, provide that foreign investment (including investment from Hong Kong, Macao and Taiwan) is permitted only in the form of a Chinese-foreign equity joint venture; no wholly foreign-owned enterprises may be established. The Regulations differentiate between joint ventures providing basic telecoms services and those engaged in providing value-added services in terms of minimum capital requirements and qualification criteria, as set out in the following chart.

Type of Service	Capital Requirements for National and Interprovincial Service	Qualification Criteria
Basic	RMB 2 billion (US$2,493,765).	Must be 51% state-owned One Chinese investor must (i) own more than 30% of the total Chinese investment, (ii) have funds and professional personnel appropriate to the business activities to be engaged in and (iii) meet the industry specific requirements set forth by MII One foreign investor must (i) own more than 30% of the total foreign investment, (ii) have funds and professional personnel appropriate to the business activities to be engaged in, (iii) have a basic service license in its place of incorporation and (iv) meet the industry specific requirements set forth by MII
VAS	RMB 10 million (US$12,468).	No requirements regarding Chinese investors Principal foreign investor must have a good record and operating experience

The Foreign Investment Regulations state the geographic scope for foreign-invested joint ventures will be determined by MII. This will allow MII to gradually lift geographic restrictions in accordance with China's WTO commitments. The Regulations also provide that the maximum percentage foreign investment will eventually rise, again in accordance with the WTO commitments.

The Foreign Investment Regulations require a cumbersome approval process. The venture must get an Approval Opinion from MII, followed by an Approval Certificate from the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). The principal Chinese investor then needs to obtain an Operating Permit from MII and finally register the joint venture with the State Administration for Industry and Commerce.

MII has set deadlines for its actions, promising to complete the examination of a basic services joint venture within 180 days and joint venture for interprovincial value-added services within 90 days of receipt of the application. Some projects require approval by the State Development and Planning Commission or the State Economic and Trade Commission, in which case the period for examination will be extended by 30 days. MOFTEC is supposed to complete its review within 90 days of receiving the application.

OUTSTANDING ISSUES

Both the Telecom Regulations and the Foreign Investment Regulations are a mixed bag. They represent a faithful implementation of WTO commitments in the more technical areas, such as competition safeguards and interconnection and the beginning of transparency in a country where the rules have not been clear for many years. But the respective regulations are disappointing in the following respects.

Taken together the Telecom Regulations and the Foreign Investment Regulations severely limit the pool of Chinese joint venture partners. As noted above, the Telecom Regulations require that a basic services licensee must be 51% owned by a state enterprise. The Foreign Investment Regulations stipulate that a telecom joint venture must be an equity joint venture, to which the Chinese party contributes cash, tangible assets or a limited kind of intangible assets equal to its equity interest in the joint venture. So a foreign investor is limited to partnering with the state-owned enterprises with cash or assets to contribute to the joint venture.

The approval process remains long and complicated. The deadlines for MII and MOFTEC approval are such that it could easily take nearly a year to establish a basic telecom services joint venture and more than half a year to establish an inter-provincial value-added services joint venture. The process is further extended by the need to develop and submit the various business plans and joint venture documents for approval. In addition, none of the regulations make clear the criteria that MOFTEC will apply in reviewing applications.

The regulations do not address the complex questions raised by the geographic limitations in the WTO commitments. Are the restrictions related to where the joint venture operates or where it is set up? For example, will a joint venture to provide paging services established in Beijing be allowed to provide service in Tianjin upon commencement of operation or only after all the geographic restrictions are lifted for those services in December 2003. Will foreign investment be permitted in an Internet Content Provider established in Shanghai that operates a web site that can be accessed from other cities in China, as well as from anywhere in the world? Until these questions are answered, foreign investors will be unable to finalize or even initiate their investment plans.

Finally, there is the question of how foreign investors can resolve disputes about China's implementation of its WTO commitments. MOFTEC is establishing a formal "inquiry point" where foreign investors can bring issues of non-compliance. But this inquiry point has been described as the first step on formal WTO dispute settlement. Foreign investors need a more informal means of addressing problems. Hopefully, over time staff at MII will develop their own expertise about WTO obligations so that MII can address disputes about implementation by its own bureaus and by provincial telecom regulators.

In conclusion, foreign investors are not wildly enthusiastic about their current chances in China's telecommunications and information services sector. But significant progress has been made. I believe that the Chinese government recognizes the need to develop the telecommunications and information sectors of the economy as a driver for growth in other sectors. If this attitude prevails, perhaps China will accelerate the implementation of its WTO commitments and provide true opportunities for foreign investors.

ATTACHMENT 1.—THE REVISED CATALOG OF TELECOMS BUSINESSES (JUNE 11, 2001)

On June 11, MII issued a revised version of the catalog of telecoms businesses attached to the Telecom Regulations. The items marked by an asterisk (*) are treated as value-added services for purposes of implementation of China's WTO commitments.

Basic Telecommunications Businesses

Domestic fixed telephony (long distance and local)

Mobile telephony (Analog mobile (large region wireless mobile,* analog trunk,* analog cellular), digital trunk, 2G digital cellular (TDMA, GSM and CDMA), 3G digital cellular)

Satellite communications (satellite mobile, satellite fixed, satellite transmitter lease and sale, VSAT*)

Internet and public data transmission services (Internet backbone network data transmission, other data network transmission (x.25, DDN, ATM, frame relay), public telegram & user telegram, wireless data transmission)

Lease or sale of network elements (bandwidth and optical communications wavelength, cable, optical fiber, optical cable, communications conduits)

Network access and hosting (network access, cable access, wireless access, network hosting)

International data, international video and graphic communication

Paging* (one-way and two-way)

Resale* (resale of basic telecoms)

International telecoms and infrastructure business (lease and sale of international ground bandwidth, optical wavelength, cable, optical fiber, optical cable and other network elements, international satellite dedicated line, international long distance telephony)

Value-Added Telecommunications Businesses ("VAS")

Fixed telephone network VAS (telephone information services, call center services, voice-mail, video conference service)

Mobile network VAS

Satellite network VAS

Internet VAS (Internet access service, Internet data center, Internet information service, Internet VPN, Internet video conferencing service, Internet call center, other Internet VAS)

Other data transmission network VAS (computer information service, electronic data exchange, voice-mail, e-mail, facsimile storage and relay, VPN)

ATTACHMENT 2.—DECREE NO. 333 OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA

The Provisions on the Administration of Foreign-Invested Telecommunications Enterprises have been adopted at the 49th regular meeting of the State Council on December 5, 2001. It is hereby promulgated and shall be implemented as of January 1, 2001. (Zhu Rongji, Prime Minister, December 11, 2001)

Provisions on the Administration of Foreign-Invested Telecommunications Enterprises

Article 1.—These Provisions are formulated in accordance with the relevant laws and administrative regulations governing foreign investment and the Telecommunications Regulations of the People's Republic of China (the "Telecommunications Regulations") in order to meet the needs of opening the telecommunications industry to the outside world and promote the development of the telecommunications industry.

Article 2.—Foreign-invested telecommunications enterprises refer to enterprises that operate telecommunication businesses jointly established in accordance with law by foreign and Chinese investors in the People's Republic of China in the form of Chinese-foreign equity joint ventures.

Article 3.—Foreign-invested telecommunications enterprises that engage in the operation of telecommunications businesses shall, in addition to these Provisions, comply with the provisions of the Telecommunications Regulations and other relevant laws and administrative regulations.

Article 4.—Foreign-invested enterprises may engage in basic telecommunications businesses and value-added telecommunication businesses. The specific distinction between the categories of telecommunications businesses set out in the Telecommunications Regulations shall apply.

The geographic scope in which foreign-invested telecommunications enterprises may operate shall be determined by the supervisory department for the information industry under the State Council in accordance with the relevant provisions.

Article 5.—The registered capital of a foreign-invested telecommunications enterprise shall comply with the following provisions:

(1) The minimum amount of the registered capital of a foreign-invested telecommunications enterprise operating a telecommunications business nationwide or in several provinces, autonomous regions or municipalities directly under the central government shall be RMB 2 billion in the case of a basic telecommunications business or RMB 10 million in the case of a value-added telecommunications business.

(2) The minimum amount of the registered capital of a foreign-invested telecommunications enterprise which operates a telecommunications business within one province, autonomous region or municipality directly under the central government shall be RMB 200 million in the case of a basic telecommunications business or RMB 1 million in the case of a value-added telecommunications business.

Article 6.—The capital contribution ratio of the foreign investor in a foreign-invested telecommunications enterprise operating a basic telecommunications business (other than wireless paging business) shall ultimately not exceed 49%.

The capital contribution ratio of the foreign investor in a foreign-invested telecommunications enterprise operating a value-added telecommunications business (including the basic telecommunications business of wireless paging) shall ultimately not exceed 50%.

The capital contribution ratio between the Chinese and the foreign investor of a foreign-invested telecommunications enterprise in different periods shall be determined by the supervisory department for the information industry under the State Council in accordance with the relevant provisions.

Article 7.—To operate a telecommunications business, foreign-invested telecommunications enterprises shall satisfy the conditions for the operation of basic telecommunications businesses or value-added telecommunications businesses set forth in the Telecommunications Regulations in addition to the conditions set forth in Articles 4, 5 and 6 of these Provisions.

Article 8.—The principal Chinese investor of a foreign-invested telecommunications enterprise operating a basic telecommunications business shall satisfy the following conditions:

(1) be a company establish in accordance with law;

(2) have appropriate funds and specialized staff for operating activities;

(3) meet the prudential and industry-specific requirements stipulated by the supervisory department for the information industry under the State Council.

The principal Chinese investor of a foreign-invested telecommunications enterprise referred to in the preceding paragraph means the investor who makes the largest amount of capital contribution among all Chinese investors and whose capital contribution accounts for over 30% of the total amount of capital contributions of all Chinese investors.

Article 9.—The principal foreign investor of a foreign-invested telecommunications enterprise operating a basic telecommunications business shall satisfy the following conditions:

(1) have enterprise legal person status;

(2) have obtained an operating permit for basic telecommunications businesses in its country or territory of incorporation;

(3) have appropriate funds and specialized staff for operating activities;

(4) have a good record and operating experience in basic telecommunications businesses.

The principal foreign investor of a foreign-invested telecommunications enterprise referred to in the preceding paragraph means the investor who makes the largest amount of capital contribution among all foreign investors and whose capital contribution accounts for over 30% of the total amount of capital contributions of all foreign investors.

Article 10.—The principal foreign investor of a foreign-invested telecommunications enterprise operating a value-added telecommunications business shall have a good record and operating experience in value-added telecommunications business.

Article 11.—For the establishment of a foreign-invested telecommunications enterprise operating a basic telecommunications business or operating a value-added telecommunications business in several provinces, autonomous regions or municipalities directly under the central government, the principal Chinese investor shall submit an application and the following documents to the supervisory department for the information industry under the State Council:

(1) a project proposal;

(2) a feasibility study report;

(3) qualification documents or relevant confirmation documents of the investors of the joint venture as set forth in Articles 8, 9 and 10 hereof; and

(4) supporting documents or confirmation documents regarding other conditions necessary for operating basic or value-added telecommunications businesses as set forth in the Telecommunications Regulations.

The supervisory department for the information industry under the State Council shall examine the above documents from the date of its receipt of the application. If the application is for operating a basic telecommunications business, it shall within 180 days complete the examination and decide to grant or refuse approval. If the application is for operating a value-added telecommunications business, it shall complete the examination within 90 days and decide to grant or refuse approval. Where approval is granted, an Examination and Approval Opinion For the Operation of Telecommunications Business With Foreign Investment will be issued; where approval is refused, the applicant shall be notified and reasons specified in writing.

Article 12.—For the establishment of a foreign-invested telecommunications enterprise operating a basic telecommunications business or operating a value-added telecommunications business in several provinces, autonomous regions or municipalities directly under the central government, when its principal Chinese investor submits an application in accordance with Article 11 hereof, it may, based on the actual situation, first submit documents other than the feasibility study report, and submit the feasibility study report after the examination, acceptance and written notification by the supervisory department for the information industry under the State Council. However, the interval between the date on which the notice of examination and acceptance is issued and the date on which the feasibility study report is submitted shall not exceed one year and such period will not be included in the stipulated time limit for examination and approval.

Article 13.—For the establishment of a foreign-invested telecommunications enterprise operating a value-added telecommunications business within one province, autonomous region or municipality directly under the central government, its principal Chinese investor shall submit an application and the following documents to the telecommunications administration authority of the province, autonomous region or municipality directly under the central government:

(1) a feasibility study report;

(2) qualification documents or relevant confirmation documents as set forth in Article 10 hereof; and

(3) supporting documents or confirmation documents regarding other conditions necessary for operating value-added telecommunications businesses as set forth in the Telecommunications Regulations.

The telecommunications administration authority of the province, autonomous region or municipality directly under the central government shall sign its opinion within 60 days from the date of its receipt of the application. If it consents to the application, it shall forward the application to the supervisory department for the information industry under the State Council. If it does not consent to the application, it shall notify the applicant and specify reasons in writing.

The supervisory department for the information industry under the State Council shall complete the examination within 30 days from the date of its receipt of the application documents with the signature for consent by the telecommunications administration authority of the province, autonomous region or municipality directly under the central government and decide to grant or refuse approval. Where approval is granted, an Examination and Approval Opinion For the Operation of Telecommunications Business With Foreign Investment will be issued; where approval is refused, the applicant shall be notified and reasons specified in writing.

Article 14.—The main content of the project proposal for a foreign-invested telecommunications enterprise shall include: names and basic condition of the parties to the joint venture, the total amount of investment, registered capital, investment ratios each party, categories of businesses for which the application is made and joint venture term of the proposed enterprise.

The main content of the feasibility study report of a foreign-invested telecommunications enterprise shall include: the basic condition, service items, business projections and development plans, analysis of investment returns and anticipated business hours of the proposed enterprise.

Article 15.—If, in accordance with the relevant provisions of the State, the investment project to establish a foreign-invested telecommunications enterprise must be examined and approved by the department in charge of planning under the State Council or the department for general administration of the economy under the State Council, the supervisory department for the information industry under the State Council shall forward the application documents to the department in charge of planning under the State Council or the department for general administration of the economy under the State Council for examination and approval before issuing the Examination and Approval Opinion For the Operation of Telecommunications Business With Foreign Investment. With respect to investment projects forwarded to the department in charge of planning under the State Council or the department for general administration of the economy under the State Council for examination and approval, the period for examination and approval may be extended by 30 days.

Article 16.—For the establishment of a foreign-invested telecommunications enterprise, in the case of a foreign-invested telecommunications enterprise operating a basic telecommunications business or operating a value-added telecommunications businesses in several provinces, autonomous regions and municipalities directly under the central government, the principal Chinese investor shall submit the contract and the articles of association for the proposed foreign-invested telecommunications enterprise to the department in charge of foreign economic relations and trade under the State Council on the strength of the Examination and Approval

Opinion For the Operation of Telecommunications Business With Foreign Investment; in the case of a foreign-invested telecommunications enterprise operating a value-added telecommunication business within one province, autonomous region or municipality directly under the central government, the principal Chinese investor shall submit the contract and the articles of association for the proposed foreign-invested telecommunications enterprise to the department in charge of foreign economic relations and trade of the people's government of the province, autonomous region or municipality directly under the central government on the strength of the Examination and Approval Opinion for the Operation of Telecommunications Business with Foreign Investment.

The department in charge of foreign economic relations and trade under the State Council and the departments in charge of foreign economic relations and trade of the people's governments of the provinces, autonomous regions and municipalities directly under the central government shall complete the examination and approval within 90 days from the date of receipt of the contract and the articles of association for the proposed foreign-invested telecommunications enterprise and decide to grant or refuse approval. Where approval is granted, a Foreign-Invested Enterprise Approval Certificate will be issued; where approval is refused, the applicant shall be notified and reasons specified in writing.

Article 17.—The principal Chinese investor of the foreign-invested telecommunications enterprise shall handle the procedure for the Operating Permit for Telecommunications Business with the supervisory department for the information industry under the State Council on the strength of the Foreign-Invested Enterprise Approval Certificate.

The principal Chinese investor of the foreign-invested telecommunications enterprise shall handle the procedure for registration of the foreign-invested telecommunications enterprise with the administrative department of industry and commerce on the strength of the Foreign-Invested Enterprise Approval Certificate and the Operating Permit for Telecommunications Business.

Article 18.—To operate an international telecommunications business, a foreign-invested telecommunications enterprise must be approved by the supervisory department for the information industry under the State Council and operate through the International Telecommunications Exit and Access Bureau established with the approval of the supervisory department for the information industry under the State Council.

Article 19.—If a foreign-invested telecommunications enterprise violates the provisions of Article 6, the supervisory department for the information industry under the State Council shall order it to correct the situation within a prescribed time limit and impose a fine between RMB 100,000 and RMB 500,000. If the correction is not made within the prescribed time limit, its Operating Permit for Telecommunications Business shall be revoked by the supervisory department for the information industry under the State Council, and its Foreign-Invested Enterprise Approval Certificate shall be cancelled by the supervisory department for foreign economic relations and trade which originally issued the same.

Article 20.—If a foreign-invested telecommunications enterprise violates the provisions of Article 18, the supervisory department for the information industry under the State Council shall order it to correct the situation within a prescribed time limit and impose a fine of between RMB 200,000 and RMB 1,000,000. If the correction is not made within the prescribed time limit, its Operating Permit for Telecommunications Business shall be revoked by the supervisory department for the information industry under the State Council, and its Foreign-Invested Enterprise Approval Certificate shall be cancelled by the supervisory department for foreign economic relations and trade which originally issued the same.

Article 21.—If approval of an application to establish a foreign-invested telecommunications enterprise is fraudulently obtained by submitting false or forged qualification certificates or confirmation documents, the approval shall be void, a fine between RMB 200,000 and RMB 1,000,000 shall be imposed and the Operating Permit for Telecommunication Business shall be revoked by the supervisory department for the information industry under the State Council, and the Foreign-Invested Enterprise Approval Certificate shall be cancelled by the supervisory department for foreign economic relations and trade which originally issued the same.

Article 22.—If a foreign-invested telecommunications enterprise violates the Telecommunications Regulations and other relevant laws and administrative regulations in the operation of telecommunications businesses, it shall be punished by the relevant authorities according to law.

Article 23.—Overseas listings by domestic telecommunications enterprises must be examined and agreed by the supervisory department for the information industry under the State Council and approved in accordance with the relevant provisions of the State.

Article 24.—These Provisions shall apply by reference to companies and enterprises of the Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan Area investing in telecommunications businesses in mainland China.

Article 25.—These Provisions shall be implemented as of January 1, 2002.

PANEL V DISCUSSION AND QUESTIONS AND ANSWERS

Chairman D'AMATO. Thank you very much.

It has been very fine testimony on the part of this panel.

Before we go to questions, I want to ask unanimous consent to include in the record testimony which was provided to us by Willy Lam, Senior China Analyst in the Asia-Pacific Office, CNN, in Hong Kong, who was invited but was unable to attend and provided us some testimony on China's media and internet policy after WTO accession.

We'll go on to questions now, starting with Commissioner Mulloy.

Co-Chairman MULLOY. During the debate in this country about China's WTO entry and the need for the Congress to pass legislation giving China PNTR as part of that process, the whole issue of why this was in our interest, part of it was that we were going to have an opening up of China, and that would be politically good both for them and for us. And people used to talk about the internet being the tool to help political discussion in China.

Mr. Hsu, on page 2 of your testimony, it says that "The internet generally enables free expression," but you say "the government can easily log the behavior of individual users," which I think then makes that a different process, and people then become concerned about what they are saying, and it is therefore less of a useful vehicle.

From what I understand, what you are saying is that to deal with that, you have to come up with some new technology now to overcome that.

First, do the other panelists think that the internet does provide that kind of opportunity for opening up political discussion in China; and second, do they agree that in order to ensure that that happens, we have to have some kind of—and I'm not a tech guy—but some kind of new technology to ensure? And who does that? It isn't clear to me.

So, one, is that a benefit for us; and two, do we have to then think about how to counter the ability to monitor people on the internet?

Roger?

Mr. UREN. The answer to the first question is yes, it is a benefit. Everything from the internet, the ability to watch a variety of television channels, the ability to read a wide array of books, magazines, and newspapers, the ability to travel overseas, the ability to meet and exchange views with foreigners either at one's home, in hotels, at seminars, or whatever—everything contributes to the process of expanding dialogue and political discussion within China both about circumstances in China and circumstances outside China.

The answer to the second question I suspect is that new technology will come willy-nilly, irrespective of whether one says it is a good thing or an essential thing or not. People just continue to develop new technologies because they find it a very interesting challenge, and as new technology has become available, if it facilitates something that you can't otherwise do, then it will end up in the marketplace, and it will go further toward making the internet a more useful contributor to the whole process of political debate and discussion.

But I think one thing to bear in mind is that China's political public is not going to spend 8 hours a day sitting at a desktop computer, engaging in political debate. So the internet is one important component of a broad process of increasing political debate that is occurring in China today.

Ms. HUGHES. I would like to bring up a broader philosophical issue, which is that you can't have perfect security and perfect privacy at the same time. If you have perfect privacy for all of your citizens, there is no ability for a government to look into terrorist networks, for example, and it could be very dangerous to have that kind of thing for any country. For our country, would we want perfect privacy for criminals? I think we have to weigh those two things, and it is a very difficult philosophical issue and is not really answered by the technology. Even if that exists, do we want that to be available anywhere in the world? In this world, I would say no—that's a frightening thing to me.

Also, digital technology of any kind, the good things about it—that it can be copied easily, that it is easy and cheap to transport—all of those things are also the bad things about it. That means that it is more difficult to control, and it can cause problems for governments, and it can cause problems for the holder of the intellectual property.

I think those things will be solved, though. Intellectual property and that part of it will be solved by the growth of those industries within China itself. If you are a Chinese software manufacturer or content manufacturer, you aren't going to do any of those things if there is no protection for your property as well.

A lot of these are developmental problems, and really, on the political side, I think anybody in China today who has access to a phone line to Hong Kong can get on any site. And the blocking of the sites that we have seen is sporadic. I think that is another misconception about blocking of sites in China.

Chairman D'AMATO. Mr. Lin?

Mr. LIN. One comment I want to make is that actually, the U.S. Government has the right to look at or track every, single click and move that you make on your computer as well. In fact, in our particular experience, we have helped the U.S. Government track down some of the folks who have been using our various email and bulletin boards to conduct pirating activities and so on.

So the technology is there for any government—anyone—if you click your mouse on anything, it is there; it is recorded somewhere else.

Having said that, the Chinese Government does this more often that, let's say, the U.S. Government does, and particularly for our side—we have 30 million registered users—the amount of traffic is huge, particularly on our bulletin boards. The government does not really have a huge number of censors just sitting there, looking at every, single—you can picture like the movie "Matrix"—bit that comes across.

I think what really catches their attention is whether or not there is a momentum in the population out there trending toward a particular topic. You have millions of messages going around every day, and any one person can say anything about anybody at any given time, and that is just noise—nobody is looking at it—but if they see that all of a sudden, there is a popular wave about, say, the September 11 attacks, they get that on their radar screen. If they see a popular wave—for example, as Dr. Hsu talked about with the firecracker incidents that happened, and that was posted on SINA and was picked up by the Western media immediately—that gets on their radar screen.

So in terms of encryption technology, as far as the running of our website, that really has no bearing at all. It really is how many people are there out there that are contributing to a particular topic, and if that number reaches a very high critical mass, that is when the government will pay attention to it.

Co-Chairman MULLOY. Did you want to say anything more on that issue, Dr. Hsu?

Mr. HSU. Just a couple comments. I think that any large corporation that wants to do business in China is to some extent going to have to be complicit with the government there, because if your main motive is profit, why should you butt heads with the local government.

Therefore, the content is to some extent prescreened by Yahoo China, by SINA, because they don't want to get in trouble.

Secondly, certainly the chat rooms play a role even as they are in furthering democracy. They help the press, they help the government itself see what is in the minds of the people. But with technology improving so rapidly, it is very, very easy to just record what everybody does. And if you see a movement starting to get out-of-hand, you can go back and look at all the postings and decide who are the heads of this movement and who needs to be locked up. So that is a capability that the government is going to have.

As I said, in general, I think the internet cannot help but free expression and free information, but I think people should be aware that the Chinese Government takes it very seriously, and they are actually building the infrastructure now to be able to control it.

Co-Chairman MULLOY. Ms. Sherman, did you have anything more to add?

Ms. SHERMAN. Yes, there is something I wanted to add. In the telecom regs that were issued a year ago, there is a description of what is illegal content—actually, I refer to it in my testimony. The service provider, the person who provides the telecom network, is in part responsible for stopping that illegal content. My fellow panelists are all shaking their heads because they are all service providers and subject to the content rules.

These content rules, I noted in my testimony, make foreign investment very difficult. It is not clear exactly what content is prohibited; it is also not clear how you could stop the transmission in many cases. But the PRC government certainly tried to put out in regulations the fact that there is certain content that you cannot transmit.

Chairman D'AMATO. So the service provider gets to decide whether he goes out of business if he goes too far beyond those limits.

Ms. SHERMAN. No. The service provider, theoretically under the regulations, is held liable for the content. Whether the service provider could actually do something about that content is something you really need to address to Mr. Lin and Dr. Hsu, because it is a technical issue. My problem is that the Telecom regs contain a broad description of content that is, quote, "illegal," and it is very hard to tell when you fall in the legal and when you fall in the illegal part.

Mr. HSU. If I could comment, I think that is how they compel good behavior from the corporations that operate there. The current regulations actually require internet entities to be able to identify and record who makes which comments and who accesses exactly what information on a particular web service. Now, whether that is in force, I don't know; it seems to be at the current level of development, I think, impossible to enforce. But those laws are on the books.

Co-Chairman MULLOY. That was very helpful. Thank you.

Chairman D'AMATO. Commissioner Ledeen?

Vice Chairman LEDEEN. Dr. Hsu, could you describe the reaction of the government to SafeWeb—have they noticed it?

Mr. HSU. Oh, of course they have noticed it, yes.

Vice Chairman LEDEEN. Have they whispered in your ear?

Mr. HSU. I have not had any direct communication, but our servers are attacked fairly frequently. The actual addresses of——

Commissioner LEWIS. What does that mean, "attacked"?

Mr. HSU. The unit of information transfer on the internet is a "packet," and you can occupy a server, bring it down, if you will, by sending it all kinds of malformed packets that it has to react to; so that is basically an attack.

Chairman D'AMATO. So they shut you down?

Mr. HSU. No, they are not able to actually shut us down, but we have been attacked——

Commissioner BECKER. Overload.

Mr. HSU. Well, yes, but we are pretty good, so we have never actually been overloaded.

One of the applications of our technology is that we have a piece of software called "Triangle Boy," which if you were to install it in your computer, your computer would act as an entry point for users in China into our network. They spend a certain amount of effort to try to track down all the computers in the world that have that software installed and add those internet protocol addresses to their block list. So we are playing this sort of cat-and-mouse game—we, also with the cooperation of Voice of America—in trying to create as many of these entry points as possible, where they try to find them and block them immediately.

Mr. LIN. I have to make one comment, which is that actually quite a lot of the illegal activities that we deal with are not political in nature. Actually, the people who are using the technology to shield identities, actually, many of them use that to trade let's say pornographic pictures and conduct other activities. So the technology can be used in many ways. I think the Western media tend to focus very, very much on the political nature of it because that is the one thing that gets people to read their papers. But we deal with a lot of activities where people are trading in pornographics or gambling information, and that never gets picked up.

Commissioner LEWIS. How about drugs; drugs, too?

Mr. LIN. You can use the internet to sell anything, and particularly people who have something to hide like to hide behind a screen so that no one can track down their identity.

Vice Chairman LEDEEN. Dr. Hsu, could you describe the way that SafeWeb works for me in this sense—that is, the government cannot decrypt it, right——

Mr. HSU. That's correct.

Vice Chairman LEDEEN. —but can they identify the endpoints of messages, of communications?

Mr. HSU. No, not unless they come to us and force us to reveal our logs to them. But our logs are destroyed periodically.

Ms. SHERMAN. Like Arthur Andersen.

[Laughter.]

Vice Chairman LEDEEN. I have been on SafeWeb—I daresay I am the only person here who has been on it.

Mr. HSU. I just want to comment that before we launched the service, we didn't know what the fraction would be of adult content or illicit content, and we analyzed it very thoroughly after putting it up, and it is not significantly higher than the internet in general, so about 25 percent of the bandwidth is used for what appears to be access to adult sites, but that is not particularly different from the actual internet as a whole.

In fact, if you look at the most accessed sites through SafeWeb from China, they are all Chinese language news sites that they couldn't otherwise get access to.

Vice Chairman LEDEEN. Mr. Uren, would you indulge me for a quibble on your use of language at one point when you referred to a group that was associated with "The China That Can Say No," and referred to them—whom I have always thought of as national chauvinists verging almost on racists; they are a nasty bunch of people—you referred to them as "neoconservatives," because my children, who consider me a neoconservative, would be upset to think that neoconservatives embrace that sort of thought.

Mr. UREN. Let me assure you, Commissioner, Vice Chairman, that I am only talking about neoconservatives in the Chinese context—and please pass that on to your children.

[Laughter.]

Vice Chairman LEDEEN. What makes them neoconservatives?

Mr. UREN. Because they are not really conservative in the Chinese sense.

Commissioner LEWIS. Maybe you could use the word "pseudo" instead.

Vice Chairman LEDEEN. Excuse me. This is serious.

Mr. UREN. They are not really conservative. They sort of pose as conservatives in the Chinese context.

Vice Chairman LEDEEN. Yes, but that's not what "neoconservative" means, Mr. Uren. "Neoconservative" here, at least, refers to people who were liberals and who then transmogrified because they found that liberal vision of the world did not fit the facts, so they moved toward a more traditional conservative position. That is what "neoconservative" means.

Mr. UREN. Precisely. In this case, a lot of the people who have at certain stages in their careers been liberal and outward-looking and then, in many cases because of the very undifferentiated criticism of China after Tiananmen, found themselves drawn by the sort of nationalistic response to that Western criticism to a more conservative position, which wasn't conservative in any genuine sense, but drew on——

Vice Chairman LEDEEN. It would be paradoxically a conservative, pro-Communist regime position.

Mr. UREN. Not pro-Communist; more sort of nationalist, as you said, with a chauvinistic dimension to it; critical of the Communist apparatus because they recognize that it doesn't work.

Vice Chairman LEDEEN. Right; because it failed.

Mr. UREN. Yes. And I think everyone acknowledges that in China today. They are also a group—and I think this differentiates this group of people from the phenomenon in the West, including in the U.S.—they are people who are trying to use a rather provocative type of language in order to stake out a sort of political playground or political stage on which they can draw attention to themselves, and they try to promote themselves within the political system there.

Vice Chairman LEDEEN. Thank you.

Chairman D'AMATO. Commissioner Robinson?

Commissioner ROBINSON. Thank you, Mr. Chairman.

I think this has been extraordinarily interesting and useful, and I very much appreciate all of your tenacity in staying with us here.

First, Ms. Hughes, I congratulate you on Chinaonline. I am one of your clients, so to speak. We have made great use—and I believe the Commission as well has made substantial use—of Chinaonline, particularly in my interest in the financial sector and capital markets and a range of Chinese business operations. It is a very fine product.

Ms. HUGHES. Thank you.

Commissioner ROBINSON. And Dr. Hsu, I'd like to come back to a point that Commissioner Ledeen made. I too am intrigued by Triangle Boy and your proposition that with some expenditure but not huge expenditure of some millions of dollars by the U.S. Government for development and deployment, this could be a very important exercise and second opinion, if you will, or breaking the stranglehold and the monopoly on the flow of information, particularly during periods of tension, whether it be another Hainan Island type of incident or something else.

We are in the business, as you know, of looking over the possibilities of those who appear before us and trying to cull potential recommendations for the Congress in particular. I was wondering if it is possible to receive somewhat of a fleshing out of how this might actually play. You may have something like that on the shelf; I don't mean to create work, but it is just sort of a short form of how we might look at this in the terms of a proposal that the Commission could review. I can't speak for my colleagues as to where it would come down, but I can tell you that I for one find it very compelling, because I think everyone on the panel and those who have cared about this communications and internet dimension for a long time are obviously looking for how to find that better-paced car, how to find that more elusive freedom of expression, even though we are quite aware that it is being stalked by a very prodigious Chinese effort to capture that issue and thwart products and initiatives such as your own.

So if you are willing, at least I would certainly, and I think others of us, would certainly be willing and very interested in receiving anything more that you might provide us on that matter.

Mr. HSU. I'd be happy to.

Commissioner ROBINSON. Fine. Thank you very much.

Chairman D'AMATO. Thank you very much. We look forward to that.

Commissioner Reinsch?

Commissioner REINSCH. Dr. Hsu, you said a lot of interesting things, but one in particular struck me. You said that the Chinese were in the process of trying to develop the capability to control the internet. Are they going to succeed?

Mr. HSU. That's a very difficult question. It depends a lot on what people outside are trying to do. I think that is the main observation, that because of the way the internet was constructed, what people do in one part of the world really affects what people do in the other part. If I make a resource available—if I open a big chat room here, and somehow the government there is not able to block access to that chat room by users in China, suddenly there is a venue where individuals in China can exchange ideas without the government's control.

Commissioner REINSCH. Does defeating them—and that is probably the wrong word—does making sure they don't succeed in that effort depend at the end of the day on people outside China, or does it depend on people inside China?

Mr. HSU. I think it depends on people outside China. If you take the example of Napster, which was an extremely popular piece of software, it was defeated by the local government. The local government said this is not something we want—because of their problems with intellectual property—and we are going to shut it down, so it shut down.

So the internet can only function in the context of China to further freedom (if the government does not want to further freedom) if people outside China deploy resources and make them available to users in China.

Commissioner REINSCH. Are there other products like yours that others are purveying?

Mr. HSU. Not oriented specifically at China, but there are other services which try to protect the identity and privacy of users when they use the internet. Because they didn't try to solve the China problem, in which there is a hostile government trying to block access to the resource at all times, they didn't really develop it in the same way that we did, and hence, they are all just blocked in China, and they can't be used there.

Commissioner REINSCH. I see. I confess that I am interested in your product because in my past life, I was the government official in charge of export controls on encryption software. We might have met under less favorable circumstances at some points in the past.

Mr. HSU. Well, it is a fascinating story, because the U.S. intelligence services were dead against this, but U.S. software companies were so in favor of it and the promise of E-commerce, and how can you send your credit card over the internet unless you can encrypt it in an extremely strong way, basically forced its way into these browsers. Now everyone in the world, whether they are in Baghdad or Beijing, has access to a little encryption engine. They don't know that it is in there, but it is in their laptop, and it is strong enough to defeat all the code-breakers at NSA.

Commissioner REINSCH. Would you like to estimate how many people actually take advantage of that capability and use it?

Mr. HSU. Well, actually, it's overkill, so every time you buy a stuffed animal on E-Bay, you are actually using it. But for more sophisticated purposes, very few people are using it for that.

Commissioner REINSCH. Tell me just a little bit in the remaining moments about how your product works. The Chinese don't have to download anything; they just have to access the site somewhere else?

Mr. HSU. Right. So what I reference there in terms of the installed base of encryption technology in every browser, that precludes people from having to download anything. If they have Microsoft Windows 98, they have an encryption engine built into their operating system, the government let it in—they probably didn't know that it was really in there—and now people like us have written sophisticated protocols to let people exploit the power of that encryption.

Commissioner REINSCH. What do they do? Do they go to a site——

Mr. HSU. They just have to point it at one of our servers, and as long as they can connect to that server——

Commissioner REINSCH. And how can they identify your servers?

Mr. HSU. That's a tricky question, because a lot of our Triangle Boy machines constantly change their IP addresses because——

Commissioner REINSCH. So how do they find out what those addresses are?

Mr. HSU. For example, with the VOA, the way the program currently works is that they distribute the IP addresses. They actually send a huge number of emails into China every day—800,000—and those emails carry with them addresses that people can access.

Commissioner REINSCH. Wow. Okay. Now I am beginning to understand how it works.

To the extent that the Chinese, as part of their internet control campaign, if you will, are trying to preclude Windows and force everybody to buy their own "Red Flag" software, is that going to put you out of business, or can you work around that?

Mr. HSU. No, because it really is a double-edged sword. If you want E-commerce, if you want people to be able to trade money on the internet, move money on the internet, you have to provide them with some encryption capability. Therefore, you then, if someone more sophisticated comes along, enable those people to communicate anonymously and secretly with each other. So you can't have one without the other.

Commissioner REINSCH. Yes, but that implies, probably correctly, that at some point along the way, the Chinese Government is going to realize that they have to build those capabilities in and take that step, which really is an internal action on their part. You can then exploit that once they do that.

Mr. HSU. Right. They are sort of latecomers to the internet business, so that certain things are locked in—the use of secure socket layer (SSL), which is the way that these transactions are done, is fixed; no one is going to be able to change that because there is such a huge installed base of secure socket layer on the internet.

Commissioner REINSCH. That's a good point. Very helpful.

Thank you, Mr. Chairman.

Chairman D'AMATO. Thank you, Commissioner.

I would like to ask you to switch technologies for a moment to cable television. Phoenix—you are billed, Roger, as a precursor to access to the Chinese market television from the outside. How many sets do you now broadcast to, roughly? I read 120 million; is that right?

Mr. UREN. The figures that we are seeing from both government and commercial research suggest we broadcast to about 42 million locations which, when you translate that into the total number of viewers, you get a figure of somewhere between 130 and 180 million.

Chairman D'AMATO. Now, in doing that, how does it work in terms of the content? Surely the government is not letting you broadcast anything you want to 100 million sets all day long without regard to their views on things. How does that work in terms of content?

Mr. UREN. Well, it has no access to the production of content, and basically and technically, it can't turn us off. It can go around and turn sets off within China, but if you are broadcasting off a satellite, it is just out there. And we don't just broadcast to China; if you have a big satellite dish, you can pick up Phoenix in Australia, for example; you can pick it up in Southeast Asia, Japan, and other parts of the world. So that if they don't like the content, they have no way to turn it off.

At present, their plan is to create what they call a "uniform satellite platform" so that all foreign satellite broadcasters will have their signal picked up in China on a Chinese Government satellite dish, then related to a Chinese satellite, and then broadcast to encrypted machines across the country, thereby giving them the capacity to turn off——

Chairman D'AMATO. So they will monitor you completely.

Mr. UREN. That could monitor us completely and turn us off to those encrypted machines, but it doesn't have any relevance to those people who are already viewing Phoenix and viewing other satellite broadcasters without encrypted machines.

Now, broadcasting through a uniform platform doesn't have any advantage from the broadcaster's point of view, but it puts the authorities in a position where, if they so desired, they could turn the signal off.

Chairman D'AMATO. Is that what is going to happen?

Mr. UREN. Turn it off?

Chairman D'AMATO. No—the broadcaster's platform.

Mr. UREN. They are moving ahead in that direction, and I think that eventually, at some point this year, they will put that in place, and it will actually be working; but whether they will be able to dismantle all the other currently existing satellite receiving facilities in China is hard to say. At present, they are trying to dismantle a lot of privately-owned satellite dishes in Beijing in particular. That is unrelated, I think, to the uniform satellite platform issue.

There is a question whether, that once they have the capacity to monitor and turn off foreign broadcasters whenever they so desire, will they really do so. In Beijing, in the university areas, we are downloaded and distributed on an in-house cable system, and each time—they have tried to turn us off several times, and each time, the student reaction has been such that they have immediately turned Phoenix back on, because they very quickly make the calculation that a little knowledge may be a dangerous thing, but student unrest is much more dangerous.

Now, someone here referred to the practice of filtering what one broadcasts. I think it is fair to say that Phoenix, and I guess television companies throughout the world, don't overlook the question of audience sensitivity and so forth—we don't broadcast adult movies and so forth—but we do broadcast all the news that we think is important, and as soon as the first of the World Trade Center buildings was hit, we started to broadcast and report the attack on New York and Washington, and we did that for 36 hours, and that was the only source of information that the Chinese Foreign Ministry had at the time because they couldn't get it from anywhere else. The Chinese media didn't broadcast it. The Chinese leadership clearly appreciates the fact that, through Phoenix, they can get immediate and direct news. I can't conceive of any situation in which they would think that it is worth trying to control the news that they get through Phoenix, because it is so beneficial to them—and I am talking about the people right at the top of the system. Bureaucrats at lower levels have sort of institutional interests, a desire to control this and control that and so forth, but needless to say, when you get a difference between those at the top and those at lower levels, those at the top win.

Chairman D'AMATO. One last question before we go on. How many sets are you broadcasting to outside of China, and is the same content going to both inside and outside China? Is there any differentiation?

Mr. UREN. The answer is that in Asia, the same content goes inside China and outside China. It is very difficult to give you a figure on the number of sets outside China. In Malaysia, Singapore, and Thailand it would probably be in the vicinity of 2 through 5 million; in Japan, much less. We broadcast through a cable system there.

Chairman D'AMATO. And the content is the same?

Mr. UREN. The content is the same, yes.

Chairman D'AMATO. Commissioner Mulloy?

Co-Chairman MULLOY. I wanted to follow up in something you said in your prepared testimony. You stated: "the Chinese Government remains especially sensitive about the free availability of information and appears to be committed to maintaining the capacity to control the media and publishing world.”

Do you need a license to operate in China?

Mr. UREN. You need a license if you are going to use Chinese cable, the Chinese cable system or parts of some of the cable systems that exist. We don’t need a license, but the cable operators need a license to distribute Phoenix.

We are broadcasting globally from Hong Kong, which in terms of broadcasting regulations in China is outside the jurisdiction of those regulations, so we don’t need a license to operate as long as we abide by the laws and rules of Hong Kong.

Co-Chairman MULLOY. But your distribution channel——

Mr. UREN. The people who watch it theoretically need a license, but China, of course is a big country, there is a lot of space and a lot of people, and it is very difficult to make sure that everyone has a license who has a satellite dish. A satellite dish is worth about $250 to $300—and would be smaller than the width of this table.

Co-Chairman MULLOY. So, on what you called the filtering process, which some might call self-censorship, if you get into things that the government is really unhappy about, how do they discipline you? Do they pull your licenses for these——

Mr. UREN. Well, if they pull or, say, stop a local cable system broadcasting us, that doesn’t stop us from broadcasting the same material. They can’t stop us broadcasting what we want to broadcast.

Ms. SHERMAN. They can stop the receipt.

Mr. UREN. They can stop the receipt up to a point, but it takes a lot of effort. There is a calculation that they have to make themselves as to whether stopping the receipt is really worth the effort that it requires.

Chairman D’AMATO. But if they have a single-point platform that you are talking about, it will be easier.

Mr. UREN. When that is in place, and if they are able to remove everything else that is there at present, they would have the power to do that if they wanted to, yes.

Co-Chairman MULLOY. Where do you make your money in broadcasting into China?

Mr. UREN. Through advertising.

Co-Chairman MULLOY. Through advertising. So you make money from advertising for the Chinese to buy products.

Mr. UREN. Yes, that’s right.

Co-Chairman MULLOY. Are you the largest foreign broadcaster into China?

Mr. UREN. Yes, we would be.

Co-Chairman MULLOY. And you make money off it, so your interest in being sensitive—I mean, you have got to profit, and you want to make sure—so there is a way to influence that.

Do you mainly broadcast foreign stuff, or do you report on things that are going on in China?

Mr. UREN. Both. For example, the fireworks accidents that my colleagues referred to, we also reported on; Phoenix reports on developments in China like that.

Co-Chairman MULLOY. Well, you recall that we met you in Beijing——

Mr. UREN. That's correct, yes.

Co-Chairman MULLOY. —and I am trying to reflect back on whether the hotel we were in had Phoenix.

Mr. UREN. Yes, it does. It has a Chinese channel.

Co-Chairman MULLOY. So that really gives you a lot of—and how many people—100 million, you think——

Mr. UREN. In excess of that, watching it, yes—about 42 million actual TV sets. Every three-star hotel and above gets it; every compound with foreigners living in it; a lot of educational institutions receive it; a lot of government ministries that have an international dimension to them receive it; the whole of the senior leadership watches it.

Co-Chairman MULLOY. Do any of the other panelists have any comments you want to make regarding this issue and the opening up of the media to help us fully understand?

Ms. HUGHES. I would like to say that I think the effect of the foreign media in China is still small in relationship to the changes that are taking place in the domestic media. And the reason they are changing is because 20 years ago, they were all subsidized by the state, and now they are no longer subsidized, so they have to sell advertising, they have to find some kind of programming that people enjoy watching and trust watching.

Co-Chairman MULLOY. The domestic.

Ms. HUGHES. The domestic. The domestic players are still huge, and they are the ones, I think, that—the changes taking place don't have anything to do with WTO, but with the decision within the Chinese Government that most of the Chinese media would have to find independent means of revenue. That is what is forcing the biggest change. That is what is having the greatest effect.

Co-Chairman MULLOY. And when these companies come in and can attract viewership and increase advertising——

Ms. HUGHES. It sets the bar higher.

Co-Chairman MULLOY. —then it puts more pressure on them to offer more interesting things.

Ms. HUGHES. Yes; it sets the bar higher.

Chairman D'AMATO. I'm going to have to interrupt.

Commissioner Lewis?

Commissioner LEWIS. Thank you.

I'd like to ask all of you a question that is really unrelated to what you have presented here. You are all observers of the Chinese scene, and you are sophisticated, and you have been aware of the attempts by China to join the WTO. I would like to ask each of you why do you think China wanted to enter the WTO.

Why don't you start, Ms. Sherman.

Ms. SHERMAN. I think there are a number of reasons. One is national pride. The WTO is an international organization, and China, as the largest country in the world, couldn't not be a member of the WTO.

Second, I think that WTO membership is consistent with the desire of at least the top leadership for economic reform, and WTO accession basically imposes economic reform on the country because it imposes a series of obligations——

Commissioner LEWIS. A third party forcing them to do things.

Ms. SHERMAN. —which then translates into we have to adopt the law, we have to enforce the law. There are many things that you can tell from the U.S. experience that the government wants to do, but somebody in Congress doesn't want them to do or somebody in the public, and you could say, "Well, we have to, because it is an international obligation."

So I think that joining the WTO, besides recognition of China in its place in the world, is a mechanism for bringing about economic reform there.

Commissioner LEWIS. Thank you.

Mr. Hsu?

Mr. HSU. I think that if you are a reformer in China, you view WTO as a lever that can be used as described to implement important economic reforms. But if you are the manager of an inefficient state-owned enterprise, it is going to be the death of you, and it will be a tremendous problem for many of your employees.

So I think a careful observer might say that they are taking a risk with this because it may lead to terrible social unrest, or it may lead to——

Commissioner LEWIS. But you agree with her reason——

Mr. HSU. I do, yes.

Commissioner LEWIS. Thank you.

Mr. Lin?

Mr. LIN. Yes, I agree with all the comments made before. I think another thing is in the foreign direct investments, with China getting into the WTO, it really clarifies the investment climate much, much more for foreign companies, and particularly some of the larger foreign companies that are just waiting on the sidelines looking to get into China. I think that with them being in the WTO, it really put a lot of their minds at ease.

Commissioner LEWIS. Because of the rule of law, and they know there would be transparency?

Mr. LIN. That's correct, that's correct. As Ms. Sherman made reference to, for instance, in 1999, the laws regarding the internet were not clear at all; nobody knew what the laws were. And because of the negotiations on WTO, the United States and the EU forced China to make some of these rules much more clear. That really helped the investment climate, because for you to make an investment, you have to know what you are getting into—if you are getting a dollar out of it, you won't spend more than a dollar; but the last thing you want is you thought you were going to get $10 out of it, and you put $9 in, and they come out with a rule saying you can never come out with $5.

Commissioner LEWIS. Thank you very much.

Ms. Hughes?

Ms. HUGHES. I think that we are in a WTO honeymoon right now between the United States and China and that as the reality sets in, compliance issues will be created that will be significant in China. Japan is a member of the WTO, and we have constant trade disputes with Japan. It's not a magic bullet.

Commissioner LEWIS. Why did the Chinese leadership want to joint the WTO?

Ms. HUGHES. They wanted to—I agree with Laura—it was for reform, absolutely for reform. But I think that for American companies, the sentiment for reform might not outlast this WTO honeymoon, so I think this is the time for those companies to get as many concessions and deals and so forth as they can, before the problems that inevitably will occur become more apparent.

Commissioner LEWIS. What you are saying, then, is that the government wanted to do certain things but didn't really want to be the initiator; they can say "The WTO forces us to do these things."

Ms. HUGHES. Well, they were the initiator as well. I don't think they didn't want to stay the initiator; but what I am saying is their ability to create compliance all across China is a very difficult thing to imagine.

Commissioner LEWIS. Mr. Uren?

Mr. UREN. I agree—it is national pride; it is something that legitimizes, places an additional layer of legitimacy on reform, and it also opens up international markets more for Chinese products and ultimately contributes more to the Chinese economy.

Commissioner LEWIS. Thank you very much.

Chairman D'AMATO. Thank you.

We have time for one more question. We're going to have to leave the room at 6 o'clock.

Commissioner Becker?

Commissioner BECKER. My question is sort of anticlimactic at this point. We have drifted away from "Triangle Boy" but I want to revisit that just a little bit. It may be apparent to everybody in this room except me—the Chinese Government leaders have to have special equipment developed in order to be able to do the controlling and the monitoring that they are trying to do; is that correct?

Mr. HSU. Well, I don't know what you mean by "special equipment." They have their own homegrown software; they can also buy software for this purpose from U.S. companies.

Commissioner BECKER. Yes, that's the point I was getting at. Do we furnish any of that software from United States companies?

Mr. HSU. Yes, absolutely.

Commissioner BECKER. We do.

Mr. HSU. Yes. The same software that might be used to keep your child from viewing certain things——

Commissioner BECKER. The two companies that I have in mind are Motorola, which is a high-tech company, and Siemens, which is German.

Mr. HSU. I'm not familiar with any products from those two companies that fall into that category.

Commissioner BECKER. So that we contribute, or our businesses in the United States contribute to that—and I guess business throughout the world, high-tech companies, do that—it is readily available to do that.

Mr. HSU. Yes. There was a well-publicized case of Cisco, I believe, implementing a feature set that the Chinese asked for so they could better control what access to the internet is——

Commissioner BECKER. This whole exchange has fascinated me. Mr. Lin, just one comment—I would agree with you that the monitoring of internet activities and computer work is probably available to the United States and to any other country. The difference is the consequences of that monitoring, and I think that is why we are having the kind of discussion that we are today, and that puts it in a whole different playing field.

Thank you very much.

Chairman D'AMATO. Thank you, Commissioner Becker.

Commissioner Mulloy, you had a comment or question.

Co-Chairman MULLOY. Yes, just a last one.

Mr. Lin, from what you said in regard to Commissioner Lewis' question, you were talking about the climate and making it more acceptable—you were really talking about investment. The WTO to them, I think—and I want to get your view—helps solidify investment flows—they have $40 billion a year in investment now, and they have told us that they are expecting $100 billion. So WTO entry attracts investment, it locks people's markets open, and it assures that you have some stability and some rule of law in China. Is that correct?

Mr. LIN. That is correct.

Co-Chairman MULLOY. And the investment brings strength and technology and a lot of other things to upgrade the society.

Mr. LIN. Yes, and it also brings in education. I think many of our employees in China, after having contact with U.S.-based employees, learn a lot of new concepts; and then, we also sponsor a lot of employees in China to come to the United States to study.

So overall, I think the WTO does open up Chinese society to the outside world more and more. If a person travels to the United States and they have lived in the States for 6 months or a year, and they are driving up and down the freeways in Silicon Valley, they see what other Chinese Americans and other Chinese are doing and thinking about, and when they bring that concept back to Beijing, Shanghai, Guangzhou, where our offices are, it makes a huge change in terms of how they look at the world, how they manage their business, and how they conduct their lives. And I think that with the WTO, with more and more investments, with U.S. companies putting investments in there and sending Americans in there, it will contribute to the overall increasing awareness of the general population about what is going on outside.

Co-Chairman MULLOY. Thank you.

Chairman D'AMATO. This Commission is very interested in this subject and will remain interested in it as the technology moves forward, to see how it is actually being used, being monitored, what the opportunities are and the dangers. So like it or not, you folks are members of our permanent Commission investigating body, and we would like to stay in touch with you. In terms of the cable TV, too, this is something that is of great interest to us.

So thank you all for coming. This was a very good panel.

This concludes today's hearing. The Commission will adjourn, to meet again in a business meeting on January 28 at 10:30 in the Commission offices.

Thank you.

[Whereupon, at 5:52 p.m., the proceedings were adjourned.]