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**Public Hearing on
U.S.-China Joint Commission on Commerce and Trade Working Group on
Structural Issues**

***China's Fiber Resources and Forest and Paper Products Industry
Development***

Draft Statement – May 19, 2004

Executive Summary

In the past five years, China's wood, paper and pulp processing capabilities and resulting production and exports of paper and wood products have both expanded significantly. Foreign paper companies are playing an increasingly important role in the expansion of China's paper manufacturing capacity. At the same time, China's demand and imports of fiber raw materials to fuel these processing operations has been steadily rising. With domestic paper and paperboard demand projected to reach 70 million metric tons by 2010, up from 48 million tons in 2003, this resource and production gap would only continue to grow.

To address the resource and associated foreign exchange burden that this consumption growth would bring, China has undertaken an aggressive industry development plan, backed by policy directives and funding, to speed the development of the pulp, paper, and wood processing industries, setting out an overall objective of:

- 13.33 million hectares of fast-growth-high-yield (FGHY) plantation development between 2001 and 2015 (estimated investment required US\$8.65 billion);
- Paper/pulp production capacity increases totaling 14 million tons of paper and 1.5 million tons pulp by 2005;
- Support for ten major wood processing projects, representing capacity increase of 2.72 million cubic meters of production, by 2005;
- In total, investment of over US\$24billion in this sector through 2010, with forty-two integrated forestry plantation/pulp/paper projects identified, involving both domestic and foreign investment.

Policies

China has taken a "carrot and stick" approach to achieve these objectives, adopting tax, investment, and trade policy measures to promote domestic industry development. Incentive measures have included preferential financing arrangements funded in part through subsidized domestic bank loans:

- Loan interest subsidies for technology renovations and capacity installments at twenty-one State-owned paper-processing projects. US\$1.67billion between 1998 and 2002;
- Loan interest subsidies for the development of FGHY plantations. US\$1.73billion budget through 2015;
- Below market interest rates and extended repayment terms for FGHY plantation investments.

Since China's wood processing sector is more labor intensive, most Central Government development and subsidization policy is focused on the pulp and paper sector, which requires larger capital investment. To date, most subsidies have been extended to domestic companies, but it is expected that foreign invested entities will soon become eligible as well.

- One of the most important aspects of the new policies has been the devolution of investment approval authority to local governments. While this has expedited investment approvals, it has also resulted particularly in loosened financing policies, resulting in local banks engaging in 'non-standard' banking or investment practices. Examples of these actions include debt forgiveness, extended loan repayment terms, and preferential loan interest rates to selected enterprises.

China has also reduced a variety of industry and agricultural taxes and tariffs in order to attract investment in forestry projects and processing industries, and stimulate trade to meet China's fiber needs, including preferential Value Added Tax (VAT) provisions.

At the same time it is adopting incentive policies to attract investment. China has also made increasing use of trade policy and other tools to push foreign companies to move processing operations on shore.

- Over the last five years, China has carried out a number of anti-dumping cases in several paper product categories, against U.S. and foreign producers. While one objective has been to protect less competitive State-owned producers, it has also become clear that China is using these investigations to give a competitive advantage to new producers and to encourage international players to invest in Chinese production.
- In fact, Chinese anti-dumping procedures have allowed domestic companies, in some cases 1-2 large players, to manipulate the process to gain strategic advantage and market share. Moreover, the government, led by the Ministry of Commerce (MOFCOM) is likely to support more anti-dumping investigations such as the one launched on March 31 on imports of linerboard from the U.S., South Korea, Taiwan and Thailand. There are rumors that white paperboard could be a target of future anti-dumping action as local capacity of that grade continues to grow.

Industry Impact

China's pulp, paper and wood processing sectors have rapidly modernized in recent years, becoming increasingly competitive in international markets with higher quality and more value added production. In the paper sector, participation by foreign operators has been a major source of increased capacity.

This sector's capacity expansions are by and large being driven by a small group of foreign invested projects and multinational companies, with APP China the most prominent.

China's industrial and tax policies, combined with the country's anti-dumping investigations, have directly influenced the sector's capacity expansions, and have enabled China to become increasingly self-sufficient in most paper grades, including newsprint, coated wood-free paper, linerboard and white board. Even in certain higher grade segments, such as KLB and SBS packaging paperboard grades, imports have dropped considerably, and it can be expected that the markets for imports in most grades will continue to shrink.

A significant amount of this increased capacity, however, is still underutilized owing to high costs of fiber, high taxes and slim profit margins. In many instances, idle or under capacity enterprises are being kept afloat by local governments or local bank support.

In the wood sector, China's production and exports have likewise been growing strongly, led by plywood and furniture but has yet to develop significant production of structural products. Those products that are more labor intensive have been the most successful, but specific preferential VAT policies have also benefited the panel industry. This sector is still largely dominated by domestic producers, but foreign companies, particularly from Taiwan and Hong Kong, have invested heavily in China.

One of the biggest question marks going forward is China's ability to attract investment and achieve its forestry/fiber resource and processing capacity objectives. Many observers believe that limited domestic fiber resources, tighter controls over investment spending energy shortages, and natural environment, among other constraints, will likely force China to continue to rely heavily on imported raw material fiber sources and imports of specific higher value-added paper and wood products for the foreseeable future.

Key Findings

Within the last 5 years, the Chinese government has determined ambitious capacity expansion targets for its pulp, paper and wood processing industries. To achieve its objectives, a series of aggressive development policies have been set in motion, backed by central government policy directives and funding, to speed the development of its pulp, paper, and wood processing industries.

These policies are premised on the following objectives:

1. Reduce China's dependence on imported fiber raw material, paper, and processed wood products by developing the domestic wood fiber base through:
 - Development of fast-growth high yield plantations
 - Reduction of high taxes and fees on plantations to stimulate investment
 - Tariff reductions on imports of raw materials
 - Protection of China's forestry base
2. Encourage foreign investment in the wood fiber, pulp, paper and wood processing sectors through a variety of financial and tax incentives.
3. Promote exports of high-value added wood and paper products through VAT tax rebate subsidies (although many of these VAT rebates are being reduced, some are still in effect for certain wood and paper product sectors).¹
4. Subsidize the restructuring of State-owned pulp/paper and wood processing companies through:
 - Government loans and loan subsidies for technology renovation
 - Promotion of foreign investment in State-owned enterprises
 - Protection of debt-ridden State-owned enterprises that maintain excess / idle capacity / production lines through local government soft loans and loan forgiveness

To further ensure achievement of capacity and policy objectives, a key point of the central government's development policies has been to devolve decision-making power for approval of new investments to local governments. This has had the two-fold effect of greatly expediting investment approvals and significantly improving the scope and content of favorable development policies offered to domestic and foreign investors alike. In practice, local governments have gone well beyond central government directives when offering development policies, including tax, financing and trade, in support of attracting investment in their regions. Finally, local governments have been extremely supportive of domestic industry in applying to the central government to receive specific preferential policies (e.g., central government loan interest subsidies for paper companies investing in plantation projects).

¹ Although VAT tax rebates are gradually being phased out over time, especially on commodities such as timber and pulp, it is expected that they will remain indefinitely on high-value added products (i.e., fiber board, plywood) to promote exports of these goods. Any further reductions of the VAT tax rebate on these high value added goods in the future are expected to be marginal.

Government Capacity Expansion Targets

- **Fiber Resources:** Development of 13.33 million hectares of fast-growth-high-yield (FGHY) plantations between 2001 and 2015 requiring an estimated investment of US\$8.65 billion.
- **Paper/pulp:** Increases in paper/pulp production capacity; 14 million tons of paper and 1.5 million tons of pulp by 2005.
- **Wood Processing:** Ten major wood processing projects are planned for completion by 2005, representing a total capacity increase of 2.72 million cubic meters of wood products.

Finance and Investment Policy

- **Central Government's Loan Interest Subsidies:** US\$ 1.73 billion has been designated by the Ministry of Finance (MOF) for the development of FGHY plantations by 2015.
- **Central Government's Loan Interest Subsidies:** US\$1.67 billion has already been provided by the Ministry of Finance (MOF) for the technology renovations of twenty-one State-owned paper-processing projects across China from 1998 to 2002.
- **Policy Bank's Low Interest Rate Loan and Long Repayment Term:** FGHY plantation projects receive low interest loans at 90% of the standard rate with extended repayment terms between 10-15 years (normal repayment terms are between 3-5 years).
- **Local Government's Fast Track Approvals:** Local government's have been permitted to issue fast track approval, bypassing central government authorization, for integrated plantation/pulp/paper projects resulting in:
 - Large-scale influx of foreign investment, particularly in the area of paper processing, within certain forestry-rich provinces across China where investment incentives offered by local governments are particularly favorable (e.g., Guangxi, Hainan).
 - Foreign investment in tree plantations aiding development of China's wood fiber base in the medium to long term (i.e., 5 to 8 years).
 - Accelerated capacity expansions, particularly in the wood fiber and paper product sectors.

Role of Financial Institutions

- **Domestic banks play the leading role in providing loans to forestry/paper/pulp enterprises.**
 - a) The China Development Bank and Agricultural Bank of China have been providing the majority of financing to these sectors in the form of policy loans and allocation of loan interest subsidies.
 - b) Domestic commercial banks also provide financing, primarily to the forestry industry, in the form of loans and loan interest subsidies although the latter is primarily administered through policy banks (i.e., the Agricultural Bank of China and the China Development Bank).
 - c) To date, domestic banks have not issued official preferential policies favoring domestic wood and paper enterprises over foreign companies.

Domestic Banks Engage in Widespread Non-standard Practices

- Domestic banks have engaged in a variety of non-standard banking practices to attract foreign investment into certain provinces/localities, including:
 - Debt forgiveness and debt for equity swaps
 - Extended loan repayment terms
 - Preferential loan interest rates above and beyond central government policy
- The majority of these practices occur at provincial and municipal-level banks and are made to either:
 - Attract foreign investment or...
 - To protect domestic State-owned enterprises from competition

- **International banks are playing a less important role in the financing of paper and wood enterprises in China.**

a) Since the mid-1990s, the World Bank and the Asian Development Bank have focused almost exclusively on sustainable forestry development, environmental protection and infrastructure construction projects.²

✧ **Tax Policy**

- **Reduction on Forestry Taxes/Fees:** Reduction or elimination of agricultural fees and taxes for companies developing forestry resources.
- **Tax Holidays:** “Two-Free and Three-Half” tax holidays to attract foreign investment.
 - a) More preferential terms, not governed by national laws, can be negotiated by local governments on a case by case basis including:
 - VAT exemption if enterprises use certain grades of wood for production.
 - Local income tax returned to enterprise; percentage varies by region.
- **Preferential Value Added Tax (VAT) Rate on Border Trade:** Allowing large volume of Russian wood and pulp flow into China.
- **Reduction of Export VAT Rebates:** VAT rebates on all wood/paper exports (except for particle board and plywood) will be reduced to zero starting from January 1, 2004.

✧ **Trade Policy**

- **Tariff Measures**
 - a) Zero tariff on logs/lumber and pulp/waste paper beginning in 1999 to supplement the insufficient domestic supply.
 - b) Tariff exemption for high-grade paper machinery to support technology renovations in large State-owned enterprises and encourage foreign investment in China.
 - c) Continued tariffs on higher value wood and paper products.

² There are two main reasons for the World Bank (WB) and the Asian Development Banks' (ADB) move away from providing loans to China's wood and paper sectors. The first reason had to do with the high risk associated with providing loans to these sectors. Prior to the mid-1990s, the WB and ADB did provide loans to small-scale paper enterprises and projects. However, the majority of these projects funded by the WB/ADB were unsuccessful and/or unprofitable; causing these institutions to shift their loan strategy to other sectors in the Chinese economy. The second reason had to do with Chinese wood/paper enterprises' demand for such loans. Once China was classified by the WB/ADB as a developing market economy in 1999, according to standard policies, loan interest rates offered to industry projects became less preferential than in prior years. Chinese enterprises, realizing that the loan interest rates offered by the WB/ADB were now comparable to domestic institutions, preferred to source funding from domestic banks as such loans were more easily obtainable.

- **Anti-dumping Investigations**

- a) Protect less competitive State-owned producers through the continuing of prohibitively high tariffs on newsprint imports.
- b) Promote domestic investment – including international players – in coated wood- free, by effectively controlling the level of imports which are mainly coming from Japan and Korea.
 - Chinese anti-dumping procedures have allowed some domestic companies, in some cases 1-2 players, to manipulate the process to gain a strategic advantage and market share.
- c) The government, led by the Ministry of Commerce (MOFCOM) is likely to support more anti-dumping investigations after having seen new foreign investment in newsprint and coated wood-free in the wake of A-D cases in these sectors.
 - At the request of a small number of Chinese linerboard producers the Ministry of Commerce on March 31 initiated an antidumping investigation against kraft linerboard and test linerboard suppliers from the U.S, South Korea, Taiwan and Thailand.

Impact of Development Policies on Paper and Wood Industries

- Designation of forty-two pulp/paper projects, involving both domestic and foreign investment, for approval and implementation by 2010.
- Targeted investment of US\$2.13 billion to fund thirteen of the forty-two projects that are designated for fast-track approval by the government (these projects will be funded in part through domestic bank loans whose interest is subsidized by the central government for a 2 to 3 year period).
- Encouragement of all sources of foreign and private investment in the development of forestry plantations.
- Empowering local governments to have more freedom for the approval of foreign investment projects in both forestry plantations and large-scale processing facilities.

Experience suggests that limited capital and other constraints will force China to continue to rely heavily on imported fiber sources including lumber, wood base pulp and recycled paper.
