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BY HAND DELIVERY

The Honorable James J. Jochum
Assistant Secretary for Import Administration
Attention: Import Administration
Central Records Unit, Room 1870
U.S. Department of Commerce
14th Street and Constitution Avenue, N.W.
Washington, DC 20230

PUBLIC DOCUMENT

Re: Comments Regarding Public Hearings On The U.S.-China Joint Commission On Commerce And Trade Working Group On Structural Issues -- 69 Fed. Reg. 24132 (May 3, 2004)

Dear Mr. Jochum:

I. INTRODUCTION

The American Furniture Manufacturers Committee for Legal Trade ("Committee for Legal Trade" or "the Committee") submits these comments for the U.S.-China Joint Commission on Commerce and Trade Working Group on Structural Issues (the "Working Group") regarding structural characteristics of the Chinese economy that appear to be inconsistent with the normal experience of a market economy as well as Chinese government policies and practices that have the potential to distort the market and U.S.-China trade. The Committee for Legal Trade is an ad hoc coalition comprised of over 30 U.S. producers of wooden bedroom furniture and, together with five labor unions, is the petitioner in the pending antidumping investigation of wooden bedroom furniture from China.

The Committee is surprised by and deeply concerned about the extremely short time period and length restrictions for submitting comments on such an important issue for not only the U.S. furniture industry and its workers, but the entire U.S. manufacturing sector and its workers. The Committee has limited these comments to identifying characteristics and policies that will require substantially more investigation by the U.S. government prior to any serious consideration of whether to grant China market economy status in advance of the target date of 2016.

II. THE UNITED STATES SHOULD NOT ABANDON PREMATURELY ITS RIGHT TO TREAT CHINA AS AN NME

On November 10, 2001, China acceded to the World Trade Organization ("WTO") on the terms and conditions set forth in China's Protocol of Accession (the "Protocol").[1] Under the Protocol, WTO Members have the right to apply nonmarket economy ("NME") methodology in comparing prices in antidumping proceedings if producers "cannot clearly show" that relevant market economy conditions prevail in the industry. Section 15(d) of the Protocol provides that WTO Members may apply the NME methodology in antidumping proceedings involving imports from China until 2016.

These NME provisions were initially negotiated by the United States and included in the November 1999 U.S.-China bilateral agreement. This fifteen-year period under which NME methodology would apply to China was identified as a justification for passing Normal Trade Relations With The People's Republic Of China, Pub. L. 106-286 (Oct. 10, 2000), which implemented under U.S. law the U.S.-China bilateral agreement and China's accession to the WTO.[2] The United States should not truncate this fifteen year period and undermine the bargain reached in the U.S. Congress, especially without a comprehensive examination of the Chinese economy and a clear demonstration that China has met its burden of proof on all relevant statutory criteria.

III. U.S. LAW PROVIDES THAT CHINA MUST BE TREATED AS AN NME UNTIL CERTAIN CONDITIONS ARE SATISFIED

Under the Protocol, the use of NME methodology must be terminated if China establishes, under the national law of the relevant importing WTO Member, that it is a market economy. Thus, the United States has the discretion under WTO rules to apply its own law in determining whether China is or is not a market economy. In fact, by U.S. statute, China must be treated as an NME until the statutory criteria are satisfied for graduation to market economy status.

Under 19 U.S.C. § 1677(18), an NME is any foreign country that the Department determines "does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." The statute

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[1] WT/L/432 (Nov. 23, 2001).

[2] See, e.g., Statement to Congress of USTR Charlene Barshefsky, 146 Cong. Rec. S8539, 8564 (Sept. 14, 2000) (the November 1999 bilateral agreement "provide{s} adequate means to address the shoe and textile industries' concerns about imports from China. In particular, we would note that the agreement allows the United States to continue to use existing NME provisions with respect to China for 15 years after China's entry into the WTO."); Statement of Senator Baucus, 146 Cong. Rec. S8398, S8405 (Sept. 12, 2000) ("The United States can continue to use our non-market economy methodology in anti-dumping cases for 15 years, an important protection against dumped Chinese products.")

requires the Department to consider the following factors in determining whether a country is an NME:

(i) the extent to which the currency of the foreign country is convertible into the currency of other countries,

(ii) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management,

(iii) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country,

(iv) the extent of government ownership or control of the means of production,

(v) the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and

(vi) such other factors as the administering authority considers appropriate.

Under U.S. law, the Department has always considered China to be an NME, which means that the Department has determined that the Chinese economy does not operate based on market principles or otherwise exhibit the indicia of a market economy as measured by the above factors.

In identifying relevant structural characteristics and government policies, the Committee has attempted to use the U.S. statutory criteria, both the general standard and the six factors, as a guide. The issues identified below, however, may be relevant to a number of different factors and would otherwise be appropriate for the Department to consider in conducting any evaluation of China's NME status. The Committee can provide translations of sources identified below upon request.

IV. THE UNITED STATES MUST OBTAIN COMPREHENSIVE AND VERIFIABLE INFORMATION ON A SIGNIFICANT NUMBER OF TOPICS IN ORDER TO EVALUATE CHINA'S STATUS UNDER U.S. LAW

A. Because It Does Not Operate On Market Principles Of Cost Or Pricing Structures, Sales Of Merchandise In China Do Not Reflect The Fair Value Of The Merchandise

Under U.S. law, a market economy must operate on market principles of cost or pricing structures so that sales of merchandise reflect the fair value of the merchandise. The following information, however, indicates that China's economy does not operate on market principles because of the presence of extensive government incentives and industry promotion policies, discriminatory tax practices, and anti-competitive practices. As a threshold matter, the Working Group should conduct an in-depth investigation of these practices and require China to provide the necessary information regarding their effects on cost and pricing structures in China.

1. Incentives and industry promotion policies

Generally, the Chinese government maintains an active role in promoting its industries, and the economy still operates under the guidance of the central government. For example, economic development is guided through 2005 by the Tenth Five Year Plan drafted by the State Development Planning Commission.

More specifically, various forms of incentives to attract investment and promote exports have expanded significantly beyond their origin in special economic zones along the south-east coast and are now widespread practices by sub-national governments of all levels across China. Such incentives include discounts and rebates for the use of land, infrastructure support, and extensive export subsidies. These incentives are particularly relevant to the furniture industry.

a) Land use incentives

China's constitution specifies that all land is owned in common by all of the people. In practice, however, the Chinese government can either "grant" or "allocate" land use rights to enterprises in return for the payment of fees.[3] Hence, granting of free or low-cost land-use rights has traditionally been a major inducement to attract foreign investments in the special economic zones and is now widely used by regional governments to attract investment from other regions of China as well as abroad.

For example, the Changsha municipal government of Hunan province announced in 2001 that for investments that obtain land-use rights through lease arrangements, the rent within the first five years can be refunded by up to 70 percent.[4] Similarly, the Da Xing An Ling Forestry Administration of Hei Long Jiang Province in north-east China offers tax breaks and free-land use to attract more investment to the forestry industry.[5] Within the first five years following establishment in this region, a company's income tax and land use tax are fully redeemable. For the first three years, the company can use the land for free for its production and storage sites.[6]

b) Infrastructure support

Infrastructure services in China are still largely dominated by state monopolies. For example, the Chinese State Power Corporation owns 46 percent of the country's generation assets and 90 percent of the total electricity supply assets.[7] Despite plans to reform the electricity industry, the State energy monopoly persists and results in the absence of price competition.[8] Such monopolies enable Chinese national, provincial, and local governments to

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[3] USTR Foreign Trade Barrier Report 2004 ("2004 FTBR") at 95.

[4] See website of Hunan Overseas Friendship Association at http://www.hnofa.com/zsxx/zsdt/zsdt4.html.

[5] See website of Da Xing An Ling Forestry Administration, Hei Long Jiang Province at http://cyfzb.dxal.hl.cn/html/zhaoshangzheng.htm.

[6] Id.

[7] Current Affairs – Electricity Reforms In China Benefit Meter manufacturer, Metering International, Magazine Archive – 2002 Issue 2 at www.metering.com/archive/022/05_1.htm.

[8] China Country Analysis Brief, Department of Energy, June 2003, www.eia.doe.gov/emeu/cabs/china.html.

offer low cost infrastructure services to attract investments and to support plant expansion. The Zhongshan municipal government of Guangdong province, for instance, offers discounts on electricity rates to companies that consume electricity of over 350,000,000 watts, and the discount increases steadily as the amount of electricity consumption increases.[9]

c) Export subsidies

In 2003, U.S. industries increasingly argued that subsidized Chinese exports were displacing U.S. products in the U.S. market.[10] According to USTR, however,

> it is difficult to identify and quantify possible export subsidies in China because of the lack of transparency in China's subsidy regime. Chinese subsidies are often the result of internal administrative measures and not publicized. They can also take a variety of forms, including mechanisms such as credit allocations or low-interest loans. U.S. industry has alleged that subsidization is a key reason that Chinese exports are undercutting prices in the United States and gaining market share.[11]

In fact, information available from the Internet strongly suggests that various forms of export subsidies are avidly pursued by regional governments in China to develop export-oriented industries. For example, the Jinhua municipal government of Zhejiang province announced in 2003 that it "will continue its consistent policies of encouraging and supporting export expansion." The incentives it offers include a reward of RMB 0.03-0.05 Yuan for every $1 worth of export. For exports of high-tech, machinery, apparel, textile, and agricultural products, the reward is increased by RMB 0.01 Yuan.[12] The same reward is further increased at the county level by the Wuyi County government, with a reward of RMB 0.04-0.08 Yuan for every $1 worth of export.[13] In addition, the Jinhua municipal government will grant annual rewards of up to RMB 30,000 Yuan to companies with over $100,000 in exports.[14]

Similarly, in a news article on export promotion policies by the Qingdao municipal government of Shandong province, it was reported that the municipal government will release export promotion funds ahead of the original schedule to expedite the development of local export-oriented industries. The funds are mainly used for granting export tax refunds and export credit support. The industries being promoted include not only high-tech companies but also

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[9] See website of South China News Center-Guangdong at http://www.southcn.com/news/dishi/zhongshan/zs/200302201098.htm.

[10] 2003 USTR Report To Congress On China's WTO Compliance ("2003 USTR Report To Congress) at 34.

[11] 2004 FTBR at 72.

[12] See website of Jinhua Municipal Government at http://www.jinhua.gov.cn/0706/5803.htm.

[13] See website of Zhejiang Investment Invitation Net at http://invest.zj.com/policy/jinhua/100994.html.

[14] See website of Jinhua Municipal Government at http://www.jinhua.gov.cn/0706/5803.htm.

footwear, apparel, and textile manufacturers and agriculture producers. The funds are also being used for supporting exporting companies to attend international trade shows, to obtain international standards for their exported products, and to participate in antidumping investigations by foreign authorities.[15]

Various export subsidies have also been adopted by local governments in inland China under the "Western Region Development" program initiated by the central government during the Ninth Five-Year plan. For example, Gansu provincial government has adopted the "Preferential Policy To Implement The Western Region Development Program."[16] Article 16 of this Policy provides that for companies that invest and manufacture in Gansu province, every $1 worth of export will be rewarded by the local government with RMB 0.05 Yuan as compensation for inland transportation costs.[17]

According to USTR, U.S. government subsidy experts are currently seeking more information about several Chinese programs and policies that may confer export subsidies, but their efforts have been frustrated in part because China has failed to make any of its required subsidy notifications since becoming a member of the WTO.[18] USTR also indicated that

> the experts also continue to examine subsidies provided by China in special economic areas to determine whether any of them may be contingent upon export performance or the use of domestic over imported goods. In addition, the United States has begun investigating China's subsidization practices in the textiles industry, as well as the steel, petrochemical, machinery and copper and other non-ferrous metals industries.[19]

In the Committee's view, the Department should, at a minimum, condition further examination of the NME issue for China on its compliance with its WTO notification obligations. Moreover, the Committee urges the Department to conduct an investigation regarding subsidies in the furniture industry and to share with U.S. manufacturers all of its findings regarding subsidies across the various sectors, given that such subsidies are often pervasive across multiple sectors of China's economy.

In addition to direct export subsidies, China has also indirectly granted massive subsidies in the form of payments to state-owned banks for non-performing loans. The Chinese government has "bailed out" its state-owned banks three times in the past six years, with the

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[15] See website of Xinhua News, Shandong channel at http://www.sd.xinhuanet.com/news/2003-03/21/content_320764.htm.

[16] See "China Associated Technology and Economy Net" at http://www.cpc-info.com/cpcinfozc/wz/zc2001xb42.html.

[17] Id.

[18] 2004 FTBR at 72; 2003 USTR Report to Congress at 34.

[19] Id.

most recent bail-out consisting of a $45 billion payment to two of the largest state banks.[20] China's banks continue to carry bad loans estimated at $500 billion.[21] The Department should investigate the extent to which non-performing loans act as a subsidy to encourage exports and otherwise how these bail-outs impact investment, cost, and pricing structures and incentives in the Chinese market.

d) Furniture industry

The central government has clearly played a direct role in developing the production assets of the furniture industry in China. As noted by the U.S. International Trade Commission, in the 1980s, China's "central government allowed for a shift away from a communist-era focus on the development of heavy industry in the interior regions of the country to the development of light industry along the coast. Currently, furniture manufacturers are located throughout southeastern and northeastern China, concentrated primarily in the Guangdong province."[22] As noted in one article, "{t}he government wanted to convert the southern city of Dongguan, 50 miles north of Hong Kong, to an industrial zone specializing in exports. Officials there offered . . . tax breaks, inexpensive land and light regulation"[23] to Lacquer Craft to entice the company to produce furniture there. Lacquer Craft has also started to build a second factory near Shanghai, "where wages are lower than in southern China and <u>government incentives are even more appealing</u>."[24] A report by Oregon State University and Nanjing Forestry University also lists "government subsidies" in the furniture industry, including (1) favorable export-oriented policies; (2) plant expansion support; (3) industry parks and free trade zones; (4) international trade shows; (5) professional training; and (5) handling international trade disputes.[25]

Small enterprises, which make up the majority of the furniture industry, also benefit from a law aimed at promoting and developing small and medium enterprises ("SMEs").[26] This law (1) creates a special fund within the central budget for the sole purpose of supporting SMEs; (2)

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[20] Wen Warns Bank Over Reform, Says Failure Not An Option, <u>AFX.com</u>, March 14, 2004; Peter S. Goodman, Loans Feed Inflation In China, Regulators Say, <u>The Washington Post</u>, March 12, 2004, at E01. <u>See also</u> Section 4.G.3 below.

[21] <u>Id.</u>

[22] <u>Wooden Bedroom Furniture From China</u>, Inv. No. 731-TA-1058 (Preliminary), USITC Pub. 3667 (January 2004) at VII-1.

[23] <u>China Polishes Off Rivals In Furniture Production</u>, Los Angeles Times (Oct. 21, 2002).

[24] <u>Id.</u> (emphasis added).

[25] Jeff Xiaozhi Cao, Dr. Eric Hansen, and Prof. Meiqi Xu, <u>China's Furniture Industry</u>, at http://ahc.caf.wvu.edu.

[26] <u>Small And Medium Enterprises Promotion Law Of China</u>, available at the China Furniture Net, http://www.jiajunet.com/info/old/6997.htm, and <u>China Furniture Industry Research Paper</u>, available at the China Furniture Net, http://www.jiajunet.com/info/old/4937.htm.

allows for special tax policies to support SMEs; and (3) calls for the People's Bank of China (the state-owned central bank) to design policies to allow SMEs to obtain loans on favorable terms.

2. Discriminatory taxation favoring domestic products

Discriminatory taxation practice that favors domestic products over like or directly competitive imported products violates the WTO principle of non-discrimination and is likely to lead to distortion of market value of the merchandise subject to such taxation. China's practice with respect to value-added tax ("VAT") and consumption tax raises such concerns. According to USTR:

> Application of China's single most important revenue source – the VAT, which ranges between 13 percent and 17 percent, depending on the product – is uneven. Importers from a wide range of sectors report that, because taxes on imported goods are reliably collected at the border, they are sometimes subject to application of a VAT that their domestic competitors often fail to pay.[27]

China's 1993 consumption tax system uses substantially different tax bases to compute consumption taxes for domestic and imported products, and the tax burden imposed on imported consumer goods ranging from alcoholic beverages to cosmetics to automobiles is higher than for competing domestic products.[28] This issue has also been raised by the United States in its questions to China through the transitional review mechanism under China's accession protocol, in particular with regard to how this differential tax treatment is consistent with GATT Article III and how China plans to modify it.[29]

3. Anti-competitive practices

Finally, various anti-competitive practices are also likely to lead to considerable market distortion in China. According to the U.S. Department of State's FY2004 Country Commercial Guide for China ("2004 CCG") (and discussed further below),

> China continues to struggle with economic inefficiencies and investment disincentives created by local protectionism, predatory pricing, preservation of industry-wide monopolies, and monopolistic practices designed to protect the state-owned sector. In certain areas, industrial conglomerates operating as monopolies or near monopolies (such as China Telecom) have been authorized to fix prices, allocate contracts, and in other ways restrict competition among domestic and foreign suppliers. Regional protectionism by provincial or local authorities tends to restrict market opportunities for foreign-invested enterprises in China.[30]

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[27] Id. at 63.

[28] Id.

[29] Committee On Market Access, China's Transitional Review Mechanism, Questions From The United States To China Concerning Market Access, G/MA/W/35, para. 20 (30 August 2002).

[30] U.S. Department of State, Country Commercial Guide FY 2004, Section 6.B ("2004 CCG").

With respect to all of the incentives, discriminatory practices, and anti-competitive practices identified above, the Department should demand that China both comply with its WTO transparency and notification obligations and provide comprehensive and verifiable information in order to facilitate preliminary discussions in the Working Group.

B. The Extent To Which China's Currency Is Convertible Into The Currency Of Other Countries

In a market economy, the local currency is freely convertible into foreign currencies with no or very few restrictions. The following information indicates, however, that conversion of the Chinese Yuan (RMB) to foreign currencies is still subject to strict government control.

The People's Bank of China ("PBOC") and the State Administration of Foreign Exchange ("SAFE") regulate the flow of foreign exchange in and out of the country and set exchange rates through a "managed float" system. To better control this flow, almost all Chinese enterprises and agencies are required to turn over their foreign currency earnings to the banks in exchange for Yuan. When foreign exchange is required for import and other authorized transactions, they must apply to designated banks.[31]

According to the "Rules On Purchasing Of Foreign Currencies By Individuals," individuals inside China (including Chinese citizens and residents) can purchase foreign currencies directly from banks for up to $2000.[32] The purchase must be for the purposes specified by the Rules and must be accompanied by verifying documents.[33] For purchases of foreign currencies beyond $2000, the individual must obtain an approval from the State Administration of Foreign Exchange.[34]

On the other hand, once an individual has his/her foreign currencies converted into Chinese Yuan, only non-Chinese citizens can exchange it back into foreign currencies subject to certain limitations. Information from both the China Construction Bank and the Agricultural Bank of China shows that foreigners and overseas Chinese can exchange Chinese Yuan for foreign currencies, provided that they do so within six months from the time the Chinese Yuan is bought and show the receipt of their earlier purchase of the Chinese Yuan.[35] Similarly, Article 3 of a recent interim rule promulgated by the People's Bank of China allows the state-owned banks to delegate their right to conduct currency-exchange services to qualified agencies, but the

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[31] See id. at Section 8.B.

[32] See website of Bank of China at http://www.bank-of-china.com/product/private/a1_8.shtml,

[33] Id.

[34] Id.

[35] See websites of China Construction Bank and Bank of Agriculture respectively at http://www2.ccbzj.com/jhfw/grfw/whcx2.htm and http://www.abcsz.com.cn/operation1/yiguitong_pro09.html.

delegated services are only limited to converting foreign currencies into Yuan.[36] In order to convert the Chinese Yuan back to foreign currencies, foreigners and overseas Chinese must go to the agency's entrusting bank.[37] Article 3 also provides that for Chinese residents, once the foreign currencies are converted into Chinese Yuan, they cannot be converted into foreign currencies again.[38]

Finally, it is very difficult for foreign investors to obtain foreign currencies in order to finance their investments. For example, according to one report, "due to the strict foreign currency control by the Chinese government, the quota on foreign currency usage in mainland China is mostly allocated to state-owned trading companies and seldom to foreign invested companies."[39] According to Mr. Zeng, who has been practicing law in Mainland China for 10 years, "the difficulty {for Taiwanese business} … lies in converting Chinese Yuan into foreign currencies."[40]

The Department should request additional information regarding China's currency policies applicable to individuals, including sole proprietorships, and to commercial enterprises. These currency policies, combined with the impact of pegging the Yuan to the U.S. dollar, severely distort trade and economic conditions between the United States and China.

C. The Extent To Which Wage Rates In China Are Determined By Free Bargaining Between Labor And Management

Wage rates in a market economy are determined by free bargaining between labor and management and generally reflect the market value of labor. The following information, however, strongly indicates that Chinese workers' rights to free bargaining are significantly undermined and that labor costs in China are distorted. In addition, restrictions on labor mobility and the presence of prison and child labor also subject labor costs to severe distortions. These characteristics of the Chinese labor market have a particularly significant impact on the labor-intensive Chinese furniture industry.

According to USTR, "China does not adhere to certain internationally recognized labor standards, such as the right to freely associate or bargain collectively."[41] The Chinese government forbids its citizens from forming independent trade unions, which prevents Chinese workers from defending their own interests in terms of wages, working hours, and workplace

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[36] See website of Xinhua News at http://news.xinhuanet.com/zhengfu/2003-10/17/content_1129447.htm.

[37] Id.

[38] Id.

[39] See website of the "Taiwanese Businessmen In Mainland China" at http://www.chinabiz.org.tw/maz/InvCina/199507-017/199507-022.html.

[40] Id.

[41] 2004 FTBR at 94.

health and safety conditions.[42] In fact, the Congressional-Executive Commission on China (the "CEC") found that with respect to worker rights, China is frequently in violation of its own laws, especially those governing wages and overtime pay, work hours and overtime hours, and workplace health safety.[43]

For example, despite the requirements of Chinese labor law "in much of China, particularly in the export-producing areas of southern China, workers continue to work hours well in excess of legal limits, and for wages that are frequently not calculated according to law."[44]

With respect to workplace safety, the CEC found that "poor to non-existent enforcement of existing regulations, rather than a lack of adequate legal provisions, is the determining factor behind China's unsafe workplaces."[45] It also determined that "{d}espite having enacted new and relatively progressive laws designed to improve health and safety standards, the Chinese government lacks the will or capacity to enforce these laws."[46]

In addition, according to USTR, although the Chinese government "is slowly developing nationwide pension ... and workplace injury insurance that will require substantial employer contributions," these systems "are still rudimentary and characterized by serious funding shortfalls," in part due to widespread non-compliance among domestic firms .[47] In fact, the CEC reports that "amidst rising concern in the United States about the loss of U.S. manufacturing jobs to China, the ability of Chinese employers to avoid the expense of meeting international labor standards has continued to be a factor in China's competitive advantage."[48]

The presence of prison labor and child labor are also creating severe distortions to China's labor costs. CEC found that "{f}orced labor is an integral part of China's prison system. ... Chinese prison laborers often cannot refuse to work, and work under conditions that violate China's own law and international labor standards."[49] With respect to child labor, the new Chinese regulations on the employment of children that took effect in 2002 ban the employment of children under the age of 16.[50] The new regulations "may indicate that the problem of child

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[42] Congressional-Executive Commission On China, 2003 Annual Report, 2003 CIS J. Print 89220, 16 (October 2, 2003) ("2003 CEC Report").

[43] Id. at 15.

[44] Id. at 17.

[45] Id.

[46] Id. at 1.

[47] 2004 FTBR at 94.

[48] 2003 CEC Report at 16.

[49] Id. at 17.

[50] Id. at 18.

labor is starting to be considered at the national level. However, like other labor problems in China, recognition at the national level rarely translates into full, or even partial, implementation at the local level."[51]

The restriction on labor mobility is another factor that contributes to the distortion of labor cost in China. The cost of labor – especially unskilled labor – is low in much of China partly due to the existence of an enormous surplus of rural laborers, many of whom seek work in urban areas.[52] Although China is gradually easing restrictions under a residency registration system that discriminates against migrant workers from rural areas, these workers still face serious disadvantages as they seek employment away from their home regions.[53] Such restrictions on migrant workers reduce any residual bargaining power and lead to further distortion of the cost of labor. Moreover, the mere existence of this permit system, whether the subject of reform efforts or not, confirms that the government continues to control the labor market and distort labor costs.

The above discussion demonstrates a systematic disregard for labor rights and standards across the Chinese economy, which severely undervalues the cost of labor, especially that which would prevail in a market economy. One study indicates that the average labor cost is only five percent of those in developed countries like the United States, Japan, and Germany.[54] The Working Group should investigate whether any claims regarding reforms in this area are, in fact, being implemented at the local level.

D. The Extent To Which Joint Ventures Or Other Investments By Firms Of Other Foreign Countries Are Permitted In China

China has attracted a massive amount of foreign direct investment since its economic reform in 1979. Nonetheless, the following information shows that significant barriers to investment still exist. They not only include general barriers such as opaque and inconsistently enforced laws and regulations, but also strict sectoral restrictions on foreign investment. Foreign investment in venture capital, holding companies, and investors' access to capital markets is also strictly limited.

China revised its laws and regulations on foreign-invested enterprises to eliminate WTO-inconsistent requirements relating to export performance, local content, and foreign exchange balancing as well as technology transfer. Some measures, however, continue to "encourage" technology transfer, without formally requiring it. U.S. companies have expressed concern that

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[51] Id.

[52] 2004 FTBR at 94.

[53] CEC Report 2003 at 1.

[54] Researcher: China Enjoys Comparative Advantage In Labor Costs, People's Daily Online, http://english.peopledaily.com.cn/200211/07/print20021107_106425.html.

this "encouragement" will in practice amount to a "requirement" in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications. In addition, according to U.S. companies, some Chinese government officials in 2003 still considered factors such as export performance and local content when deciding whether to approve an investment or to recommend approval of a loan from a Chinese policy bank, which is often essential to the success of an investment project.[55]

According to USTR:

> Meanwhile, the Chinese government restricts foreign investment in sectoral projects not in line with "the needs of China's national economic development." In these sectors, foreign firms must form a joint venture with a Chinese company and restrict their equity ownership to a minority share in order to invest in the Chinese market. The Chinese government also prohibits investment in certain sectors.[56]

Even in the sectors where foreign investment is allowed under China's WTO commitments, China's implementation efforts have been problematic and foreign investors still face numerous obstacles. In wholesaling and distribution services, "foreign businesses continue to be plagued by a variety of restrictions relating to trade volumes, registered capital and prior experience."[57] For example, "China has only opened up wholesaling services and commission agents' services to joint ventures with minority foreign ownership that can satisfy a number of stringent qualification requirements and other restrictions."[58] Similar obstacles exist for the insurance and telecommunications sectors.[59] Moreover, "regional protectionism by provincial or local authorities often blocks efficient distribution of goods and services inside China. These practices may restrict market access for certain imported products, raise production costs, and restrict market opportunities for foreign-invested enterprises in China."[60]

Apart from entry barriers in goods and services sectors, several other investment issues further complicate the obstacles faced by foreign investors in China. For example, "investment exit problems, especially the difficulty of listing on China's stock exchanges, coupled with the bureaucratic approvals required to list overseas, have limited interest in establishing China-based venture capital and private equity investment."[61] Likewise, although there has been some

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[55] See 2004 FTBR at 87. See also 2003 USTR Report To Congress at 40.

[56] 2004 FTBR at 88.

[57] Id. at 78.

[58] 2003 USTR Report To Congress at 14.

[59] See id. at 57 and 61.

[60] 2004 FTBR at 91.

[61] Id. at 88.

relaxation of the restrictions on the business scope and operations of holding companies, "minimum capital requirements normally make them suitable only for corporations with several sizeable investments to manage."[62] Finally,

> foreign-invested enterprises in China remain largely unable to access domestic and international stock markets, to sell corporate bonds, to accept venture capital investment, to sell equity, or to engage in normal merger, acquisition and divestment activity. Foreign exchange transactions on the capital account can be concluded only with case-by-case official review, and approvals are subject to very tight regulatory control. These barriers to capital market access are not removed by China's WTO accession agreement.[63]

The Department should verify that China has removed discriminatory WTO-inconsistent measures affecting foreign investment at both the national and sub-national levels and that no de facto measures or practices are being used to achieve the same objectives. The Working Group should also identify those specific barriers to accessing capital and how China intends to remove them.

E. The Extent Of Chinese Government Ownership Or Control Of The Means Of Production

Government ownership or control of the means of production is likely to lead to market distortion. As noted in other sections of these comments, the Chinese government continues to own or control, *inter alia*, land-use, access to capital markets, and transportation through government regulation or through state-owned or controlled enterprises. The government also controls virtually all aspects of the energy industry, including the ownership or control of oil and natural gas reserves and those companies exploiting such reserves.[64]

In the furniture industry, lumber is the main raw material for making furniture, and timber rights largely dictate the cost of lumber. The Chinese government's ownership and control over the allocation and pricing of timber rights seriously distorts costs and pricing of furniture in China. The Working Group should thoroughly investigate the significant distortions to the Chinese economy and to the furniture industry caused by these circumstances.

F. The Extent Of Chinese Government Control Over The Allocation Of Resources And Over The Price And Output Decisions Of Enterprises

Enterprises in a market economy have full autonomy to decide the price and output of their products. The following information, however, suggests that the Chinese government still controls prices on certain products and exerts influence over the pricing behavior of private enterprises.

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[62] Id.

[63] Id. at 89.

[64] See China Country Analysis Brief, Department of Energy, June 2003, www.eia.doe.gov/emeu/cabs/china.html.

According to USTR,

> China maintains price controls on several products and services covering both state-owned enterprises and private enterprises. These price controls may be in the form of either absolute mandated prices or specific pricing policy guidelines as directed by the government and include items such as natural gas, pharmaceuticals, transportation (including freight transportation), tobacco, and certain other agricultural products. The price controls can be found in the Price Gazette of the people's Republic of China as well as on the website for the National Development and Reform Commission.[65]

Moreover, the Chinese government also exerts influence over private entities' pricing behavior by adjusting and controlling the price level of a commodity it deems "important." Chapter 4 of the "Price Law," entitled "Overall Adjustment And Control Of Price Level," provides for a series of measures the government may take to influence price levels when necessary.[66] Under Article 31, in particular, when the prices for important commodities and services have increased or will increase significantly, the State Council, the provincial and autonomous regional governments, and the governments of Beijing, Shanghai, Tianjin, and Chongqing may take intervention measures, such as setting the rate of price or profit, setting the actual price, requiring declaration of price increases, and requiring documentation of price changes.[67]

Based on this provision, the Shanghai Furniture Industry Association, for example, issued a "Rule On Pricing Behavior In The Furniture Business" on June 1, 1999 that was approved by the Market Price Bureau of Shanghai.[68] Article 7 of the Rule requires that the ex-factory price for furniture producers should be such that profits do not exceed 15 percent of the cost. Thus, the rule sets a ceiling on profits for private furniture producers that limit their ability to price their products.

The Working Party should investigate the impact of China's pricing practices and obtain verifiable information on the scope of such practices at the national and sub-national levels.

G. Other Factors That The Administering Authority Should Consider

Apart from the above-mentioned government policies and practices that are likely to cause market distortions, several other factors also indicate that China cannot be considered a market economy. These factors include the presence of a significant number of state-owned (or

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[65] See 2003 USTR Report To Congress at 34. See also Price Law Of China, available at "Price Information Net" at http://wjj.lyg.gov.cn/cont/jgf4.htm; 2004 CCG at Section 2.C ("prices for thirteen broad categories of items, including electric power, transportation, telecommunications, and some services, remain subject to varying degrees of government 'guidance'").

[66] See "Price Information Net" at http://wjj.lyg.gov.cn/cont/jgf4.htm.

[67] See id.

[68] Available at http://www.jiajunet.com/info/old/6867.htm.

state-controlled) enterprises ("SOEs") in the economy, the continued existence of state trading enterprises, and the state-owned Chinese banking sector.

1. Substantial state-owned sector in the economy

According to the 2004 CCG,

> {a}lthough China's private sector has grown tremendously since economic reforms began in 1979, state-owned or state-controlled entities continue to play the leading role in the Chinese economy. For example, traditional state-owned enterprises and corporations with majority of shares held by the state accounted for just under 42 percent of gross industrial output for the year.[69]

A 2001 survey of all enterprises established in mainland China by China's National Statistics Bureau showed that 30.6 percent of the enterprises were still state-owned and a further 22.8 percent were "collectively-owned."[70] Moreover, despite efforts to reform, the government still has strong influences over SOEs' investment, production, and sales.

Commissioner Zhang Zhuoyuan reported in a speech at the latest "People's Political Consultative Conference" held in March 2004 that by 2002 there were still 159,000 SOEs across all types of businesses. Commissioner Zhuoyuan also pointed out that in many of the SOEs where stock reforms have been implemented, the government remains the sole stock holder and these enterprises have not become an independent entity in the market.[71]

In the furniture industry, one recent study found that "{t}he majority of firms are small operations but the presence of very large companies (mainly state owned) should be recognized."[72] Another recent study of 72 Chinese furniture companies found that state-owned companies accounted for 47 percent of the sales by those companies.[73] Other sources indicate that at least 20 percent of Chinese furniture companies are state owned.[74]

Across all sectors, the lack of independent authority to conduct business seems to be a major problem despite the reform of SOEs. According to a study done by the Beijing municipal government regarding Chinese SOE's investing and financing behavior, the reasons for many

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[69] 2004 CCG at Section 2.C.

[70] See website of the National Statistics Bureau at http://www.stats.gov.cn/tjgb/jbdwpcgb/qgjbdwpcgb/t20030117_61467.htm.

[71] See Zhang Zhuoyuan, The Reform Of The State-Owned Sector Still Has A Long Way, To Go at http://www.people.com.cn/GB/shizheng/1026/2377646.html.

[72] The Furniture Industry In China, CSIL, 16 (Feb. 2003).

[73] David Robb and Bin Xie, A Survey of Manufacturing Strategy and Technology in the Chinese Furniture Industry, European Management Journal (Aug. 2003).

[74] Confronted By The WTO, What Is The Way Ahead For The Chinese Furniture Industry, China Furniture Magazine, Electronic Edition, Issue 10,

http://www.e-furniture.net.cn/magzine/1.htm.

problems with such behavior lie in the fact that SOEs have not become real market entities that can invest and finance freely. In particular, they do not have independent authority to make investing/financing decisions, and lack the incentives to do so.[75]

A similar study done by the Hebei provincial government analyzed the problems in SOEs' investing behavior due to the lack of independent decision-making authority. It stated that the current "supervision" over SOEs by the Chinese government still takes the form of "administrative approval upon review." As a result, the SOEs, which upon reform should have been independent entities in the market, still cannot become independent investors. According to this analysis, too much government intervention has already resulted in waste caused by repetitive construction/production and excessive investments in concentrated areas.[76]

According to the 2004 CCG,

> the Chinese Communist Party maintains its authority to oversee economic policies as well as managerial appointments in all financial institutions and major industrial enterprises. Although the authorities' long-term plan is to sell all or part of the government share in most SOEs and financial institutions to the public, ultimate control over managers of these assets will remain in the hands of the Party. Leading officials and bureaucratic institutions also maintain substantial authority to approve or deny investment decisions by enterprises and individuals.[77]

Finally, although the private sector in China is developing, private entities are often at a significant disadvantage when competing with SOEs. In a speech at the same conference mentioned above, Commissioner Li Yining identified several issues that must be resolved for the full development of the private economy in China. These issues included government agencies' discriminatory practices favoring the state-owned sector over the private sector, the lack of financial resources available to private enterprises due to Chinese banks' preference of lending money to the state-owned sector, and the lack of a developed credit system in China.[78]

2. Continued existence of state trading enterprises

Under the terms of China's WTO accession, the import of some goods such as grains, cotton, vegetable oils, petroleum, sugar, fertilizers, news publications, and related products can

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[75] See website of Beijing Municipal Government at http://www.bjdcyj.gov.cn/swyjs/dcyj/dcyj_dcyjkt/dcyj_yjkt_2002/dcyj_yjkt_2002_zd/t20040226_110852.htm.

[76] See website of the State-owned Assets Supervision and Administration Commission of the People's Government of Hebei Province at http://www.hbsa.gov.cn/show.asp?id=1315.

[77] 2004CCG at Section 2.C.

[78] See Li Yining, Several Impending Issues To Be Solved For The Further Development Of The Private Economy, at http://www.people.com.cn/GB/shizheng/1026/2377651.html.

still be reserved primarily for state trading enterprises.[79] Pursuant to China's WTO commitments to provide information regarding state trading enterprises, "the United States and other WTO members requested detailed information from China on the pricing and purchasing practices of state trading enterprises, principally through the transitional reviews before the WTO's Council for Trade in Goods in November 2002 and November 2003."[80] The United States, in particular, made the following requests in November 2002: (i) China should indicate when it will provide notification in accordance with the questionnaire on state trading adopted on 24 May 1960 and revised in 1998; (ii) China should list all laws, regulations and other measures issued since its accession dealing with state trading enterprises; and (iii) China should indicate what steps it has taken to ensure that all laws, regulations and other measures related to state trading enterprises have been published and are readily available, as required by Section 2(C)2 of Part I of China's Protocol of Accession.[81] According to USTR, "China has so far only provided general information, which does not allow a meaningful assessment of China's compliance efforts."[82]

3. State-owned banking sector

The Chinese government continues to control the banking sector, which is now struggling with nonperforming loans and remedying a pervasive nonmarket economy culture. According to one article, "{y}ears of politically directed lending – mostly to shore up money-losing state-owned enterprises – a virtual absence of credit-risk management, and shoddy bookkeeping practices by both banks and their customers have allowed nonperforming loans to grow steadily."[83] Another article stated that "{m}ost of the state firms still think they do not have to repay bank loans, as those are public funds injected by the government. Policy-driven lending only pushes banks to lend irrespective of credit risk to support the economy. Thus, bank loans are like equity sunk in the state firms."[84]

The 2004 CCG states that "{a}ccording to the official data from the PBOC, non-performing loans accounted for 21.4 percent to 26.1 percent of total lending of China's four big

[79] 2004 FTBR at 59.

[80] 2003 USTR Report To Congress at 38.

[81] See WTO Council For Trade In Goods, Transitional Review Mechanism Pursuant To Paragraph 18 Of The Protocol On The Accession Of The People's Republic Of China, Questions From The United States To China Concerning Trade In Goods, G/C/W/435 (November 19, 2002).

[82] 2003 USTR Report To Congress at 38.

[83] Frederik Balfour, Will China's Bank Bailout Do The Trick?, Business Week, January 26, 2004, available at http://www.businessweek.com:/print/magazine/content/04_04/b3867133_mz035.htm?mz.

[84] Chi Lo, China's Bank Reform Needs Vision, Finance Asia, May 4, 2004, available at http://www.financeasia.com/Accessories/faPrintStory.cfm?objectID=629EB732-00BC-4D2F-86C4816E50CC9315

banks in 2002."[85] In addition, "the government sets all interests rates and fees at financial institutions, distorting the cost of capital and preventing banks and other institutions from using interest rates as a way to adjust for risk. ... At present, 34 categories of interest rates remain subject to PBOC control. The full liberalization of interest rates on other deposit accounts, including checking and saving accounts is expected to take much longer."[86]

One article summarized the banking sector as follows:

> China's banking system loses its market discipline, and is inefficient in allocating capital. An effective way to rectify the distortions is to push stock market reform as part of the overall financial reform strategy. However, there is still no functional stock market in China so that households have no other way but bank accounts to park their savings. The bulk of hard-earned savings are forced continuously through bank lending to state businesses that are not earning reasonable returns.[87]

As noted above, in a recent effort to bail out bad loans, the Chinese government injected billions of dollars into the state-owned banks. It is unclear, however, whether such massive subsidies will be followed by meaningful banking reforms.

The Working Group should investigate the impact of SOEs on the ability of China to adhere to market economy principles, and the Department should require that China comply with its WTO notification obligations regarding state trading enterprises as a condition for continuing these NME discussions.

V. REQUEST TO TESTIFY

The Committee respectfully requests the opportunity for two individuals to testify at the hearing on June 3, 2004. The first would be one of the undersigned partners at King & Spalding, with the relevant details provided herein. The second would be John Bassett, President and CEO of Vaughan-Bassett Furniture Co., Inc., 300 E. Grayson Street, Galax, VA 24333. Mr. Bassett's telephone number is (276) 238-2211.

VI. CONCLUSION

The above comments are not intended to be comprehensive in light of the extremely short time period for responding on this critical issue. The Committee for Legal Trade respectfully requests, however, that the Working Group include the topics and issues identified in this submission among those for preliminary discussion and further investigation.

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[85] 2004 CCG at Section 2.C.

[86] Id. at Section 8.A.

[87] Chi Lo, China's Bank Reform Needs Vision, Finance Asia, May 4, 2004, available at http://www.financeasia.com/Accessories/faPrintStory.cfm?objectID=629EB732-00BC-4D2F-86C4816E50CC9315.

Please contact us if you have any questions about this submission.

Respectfully submitted,

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cc: Albert Hsu (via hand delivery)
Michael Rollin (via hand delivery)
Lawrence Norton (via facsimile)
Anthony Hill (via facsimile)