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May 19, 2004

PUBLIC DOCUMENT

BY HAND DELIVERY

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

Re: U.S.-China Joint Commission on Commerce and Trade Working Group on Structural Issues

Dear Assistant Secretary Jochum:

In a Federal Register notice published on May 3, 2004, the Department of Commerce (the "Department") requested comments for the purpose of identifying relevant topics and issues for discussion in the working group established at the April 21, 2004 meeting of the U.S.-China Joint Commission on Commerce and Trade.[1] As indicated in the Department's request, these discussions will focus on "the range of issues that are relevant to considering China's desire to no longer be treated as a non-market economy country ('NME') under the U.S. antidumping law."[2]

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1 U.S.-China Joint Commission on Commerce and Trade Working Group on Structural Issues, 69 Fed. Reg. 24132 (Dep't Commerce May 3, 2004) (notice of hearing and request for comments).

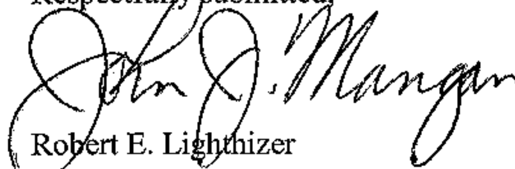
2 Id. at 24132-33.

On behalf of United States Steel Corporation ("U.S. Steel"), we hereby submit the attached comments in response to the Department's request.

We also wish to notify the Department that we intend to have a witness testify at the hearing on this matter on June 3, 2004. One of the undersigned will testify at the hearing on behalf of U.S. Steel.

Thank you for your attention to this matter.

Respectfully submitted,



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On Behalf of U.S. Steel

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BEFORE THE
UNITED STATES DEPARTMENT OF COMMERCE
INTERNATIONAL TRADE ADMINISTRATION

COMMENTS REGARDING THE NON-MARKET ECONOMY STATUS OF CHINA

May 19, 2004

SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
1440 New York Avenue, N.W.
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On Behalf of United States
Steel Corporation

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23 "China: Debt-to-Equity Swaps Help Steel Makers," China Daily (Mar. 26, 2000)

24 Comments by the American Iron and Steel Institute on China's Compliance with WTO Commitments (Sept. 10, 2003)

25 "2003 Report to Congress on China's WTO Compliance," Office of the U.S. Trade Representative (Dec. 11, 2003)

26 "Chinese Premier to Hear String of EU Trade Complaints in Brussels Today," Financial Times (May 6, 2004)

27 "EU Warns of Possible WTO Case on Chinese Coke Export Rules," Inside US-China Trade (May 12, 2004)

28 "Beijing Moves to Halt Illegal Projects," SteelWEEK (May 7, 2004)

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I. INTRODUCTION

United States Steel Corporation submits these comments in response to the Department's request for parties to identify topics and issues that are relevant to China's desire to no longer be treated as a non-market economy country ("NME") under the U.S. antidumping law.[1] Section 771(18)(B) of the Tariff Act of 1930, as amended (the "Act"), provides that, in determining whether a country is an NME, the Department shall take into account:

> (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 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 Department} considers appropriate.[2]

Whether these criteria are considered individually or collectively, the overwhelming weight of the evidence demonstrates that China remains far from exhibiting even the most basic elements of a market economy.

Indeed, in a statement made as recently as April 28, 2004, Secretary of Commerce Donald Evans referenced the six statutory criteria that must be considered in determining whether China

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[1] U.S.-China Joint Commission on Commerce and Trade Working Group on Structural Issues, 69 Fed. Reg. 24132 (Dep't Commerce May 3, 2004) (notice of hearing and request for comments) ("Request for Comments on U.S.-China Joint Commission").

[2] 19 U.S.C. § 1677(18)(B)(2001).

can be granted market economy status.[3] With respect to the first two criteria, Secretary Evans unequivocally stated that "the law is clear: China will fail to meet Market Economy status until market forces set labor and currency rates."[4] Similarly, Secretary Evans stated that "{u}ntil market forces set economic decisions – including labor and currency rates, China will remain a non-market economy."[5] As recognized by Secretary Evans, fundamental changes must be made in the Chinese economy before it may be considered a market economy. This is clear from a consideration of each of the six statutory criteria set forth in Section 771(18)(B) of the Act.

II. CHINA'S CURRENCY IS SIGNIFICANTLY UNDERVALUED AND IS NOT CONVERTIBLE

In determining whether a country is an NME, the Department is directed to consider the extent to which the currency of the foreign country is convertible into the currency of other countries.[6] As the Department has recognized,

> {a} particular country's integration into world markets is highly dependent upon the convertibility of its currency. The greater the extent of currency convertibility, for both trade and investment purposes, the greater are the supply and demand forces linking domestic market prices in the NME country to world market prices. The greater this linkage, the more market-based domestic prices tend to be.[7]

---

3 Statement from Commerce Secretary Donald L. Evans on America's Economic Relationship with China, Apr. 28, 2004, *available at* http://www.commerce.gov/opa/press/2004_Releases/April/28_Evans_China_stmt.htm ("Statement of Commerce Secretary Evans"), attached as Exhibit 1.

4 Id.

5 Id.

6 19 U.S.C. § 1677(18)(B)(i)(2001).

7 Memorandum from Albert Hsu, et al. to Faryar Shirzad, Assistant Secretary for Import Administration, Regarding Inquiry into the Status of the Russian Federation as a Non-Market Economy Country Under the U.S. Antidumping Law (June 6, 2002) ("Russia NME Memo") at Analysis of Section 771(18)(B) Factors (Public Document).

As widely reported and as recognized by officials around the globe, the Chinese government has adopted a policy of deliberately undervaluing its currency, the yuan (also called the renminbi), and that currency is not convertible into the currency of other countries.

Indeed, the yuan is, and will continue to be, nonconvertible on a capital account basis.[8] This means that export earnings in foreign exchange, plus foreign direct investment not utilized for purchases on current account, have to be sold to the Chinese central bank for yuan at a fixed exchange rate.[9] Thus, the Chinese government has intervened and continues to intervene in the market through mandatory foreign exchange sales to the central bank. In fact, China is purchasing U.S. dollars at a staggering rate of approximately $120 billion per year.[10] As of the end of 2003, the foreign exchange reserves held by the Chinese government stood at an incredible $403.3 billion.[11]

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8 "The National Security Implications of the Economic Relationship between the United States and China," Report to the Congress of the U.S.-China Security Review Commission (July 2002) ("U.S.-China Security Review Commission Report"), Chapter 2, attached as Exhibit 3; Ernest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China," Paper Presented for a Conference on the Dollar at the Institute for International Economics (Sept. 24, 2002) ("Ernest H. Preeg Paper on Exchange Rate Manipulation") at 4, attached as Exhibit 4. Chinese Premier Wen Jiabao stated in November 2003 that it would take "a very long period of time and arduous efforts" before the yuan would become fully convertible. "Country Commerce – China," Economist Intelligence Unit (Feb. 2004) ("Country Commerce – China"), at 60, attached as Exhibit 5.

9 Ernest H. Preeg Paper on Exchange Rate Manipulation at 4, attached as Exhibit 4.

10 Record of the September 25, 2003 Hearing Conducted by the U.S.-China Economic and Security Review Commission on "China's Industrial, Investment and Exchange Rate Policies" (Oct. 14, 2003) ("U.S.-China Economic and Security Review Comm'n September 25, 2003 Transcript") at iii, attached as Exhibit 6.

11 "Country Commerce – China" at 59, attached as Exhibit 5.

The purpose and effect of these large-scale purchases of foreign exchange by the Chinese central bank has been to manipulate the value of the yuan.[12] For the last ten years, the Chinese government has maintained a fixed exchange rate for the yuan relative to the dollar.[13] The rate has been pegged at about 8.28 yuan to the dollar for this entire period.[14] In other words, China has undervalued its currency through large official purchases of dollars in order to maintain an exchange rate lower than would otherwise occur under market conditions.[15] Economists have estimated that China's currency could be undervalued by as much as 40%.[16] This makes Chinese exports cheaper, and exports from the United States and other countries to China more expensive, than would be the case if exchange rates were determined by market forces.

The fact that China has intervened heavily in the market so as to artificially undervalue its currency is not disputed. Indeed, President Bush, Treasury Secretary Snow, Commerce Secretary Evans, European Union officials, and Chinese officials themselves have all acknowledged as much.[17]

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12 See Ernest H. Preeg Paper on Exchange Rate Manipulation at 4, attached as Exhibit 4; U.S. House of Representatives Committee on Ways and Means, Testimony of John B. Taylor, Under Secretary of Treasury for International Affairs, on "Economic Relations Between the United States and China and China's Role in the Global Economy" (Oct. 30, 2003) ("Testimony of Treasury Under Secretary Taylor"), attached as Exhibit 2.

13 Testimony of Treasury Under Secretary Taylor, attached as Exhibit 2; U.S.-China Security Review Commission Report at Chapter 2, attached as Exhibit 3.

14 Testimony of Treasury Under Secretary Taylor, attached as Exhibit 2.

15 U.S.-China Security Review Commission Report at Chapter 2, attached as Exhibit 3.

16 See Ernest H. Preeg Paper on Exchange Rate Manipulation at 5, attached as Exhibit 4.

17 See "Bush Again Admonishes China for Its Trade and Currency Policies," Associated Press Worldstream (Jan. 21, 2004), attached as Exhibit 7; "Snow to Press China on Currency Policies," Associated Press Online (Nov. 21, 2003), attached as Exhibit 8; Commerce Secretary Evans Statement, attached as Exhibit 1; "Euro-dollar Stability Linked to Asia Currency Developments: Lamy," Agence France Presse (Dec. 23, 2003),

(continued...)

Accordingly, it is clear that the value of China's currency is not set by the free flow of currency and goods between countries. The Chinese government's intervention in the market by maintaining capital controls, hoarding currency, and pegging exchange rates demonstrates that China's currency is not reflective of market forces and is not convertible.

III. WAGE RATES IN CHINA ARE NOT DETERMINED BY FREE BARGAINING BETWEEN LABOR AND MANAGEMENT

To determine whether a country remains an NME, the Department must also consider "the extent to which wage rates in the foreign country are determined by free bargaining between labor and management."[18] The Department has determined that "{t}he reference to 'free bargaining between labor and management' reflects concerns about the extent to which wages are market based, i.e., about the existence of a market for labor in which workers and employers are free to bargain over the terms and conditions of employment."[19] Because wages are an important component of producer costs and prices, the manner in which they are set is "an important indicator of a country's overall approach to setting prices and costs in the economy."[20] As demonstrated below, labor conditions in China are abysmal and reflect the complete absence of anything approaching free bargaining between labor and management.

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17 (...continued)
attached as Exhibit 9; U.S.-China Economic and Security Review Comm'n September 25, 2003 Transcript at 46, attached as Exhibit 6.

18 19 U.S.C. § 1677(18)(B)(ii)(2001).

19 Memorandum from Lawrence Norton et al. to Joseph A. Spetrini, Acting Assistant Secretary for Import Administration, Regarding the Antidumping Duty Administrative Review of Certain Small Diameter Carbon and Alloy Seamless Standard, Line and Pressure Pipe from Romania – Non-Market Economy Status Review (Mar. 10, 2003) ("Romania NME Memo") at 8 (Public Document); see also Russia NME Memo at Analysis of Section 771(18)(B) Factors (Public Document) (same).

20 Romania NME Memo at 8 (Public Document); see also Russia NME Memo at Analysis of Section 771(18)(B) Factors (Public Document) (same).

First, Chinese workers have virtually no freedom of association or rights of collective bargaining. The U.S. Department of State found in February of this year that the All-China Federation of Trade Unions ("ACFTU"), which is controlled by the Communist Party and headed by a high-level Party official, continues to be the sole legal workers' organization in China. Independent unions are illegal.[21] Indeed, as recognized by the Congressional-Executive Commission on China in its 2003 Annual Report,

> {t}he Chinese government denies its citizens the freedom to associate and forbids them from forming independent trade unions. The government has made no progress in the past year toward respecting this right, and continues to use the All-China Federation of Trade Unions (ACFTU) as a tool of Communist Party control of union activity. China continues the practice of imprisoning labor leaders as a means of repressing independent labor activity.[22]

In addition, workers in China have no right to strike under Chinese law.[23] In fact, the Chinese government has in the past taken swift action to halt any form of protest by workers. Protest leaders are typically subjected to harassment, arrest, detainment for long periods without trial, and, ultimately, lengthy prison sentences.[24]

The inability of Chinese workers to freely organize and bargain collectively clearly prevents them from being able to represent and defend their interests with management. Not surprisingly, Chinese workers have no effective legal or contractual protections with respect to their wages and working hours.[25] In much of China, particularly in the export-producing areas of

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21 "China: Country Reports on Human Rights Practices – 2003," Bureau of Democracy, Human Rights, and Labor, U.S. Dep't of State (Feb. 25, 2004) ("State Dept. Report on Human Rights") at 34, attached as Exhibit 10.

22 Congressional-Executive Commission on China 2003 Annual Report (Oct. 2, 2003) ("Congressional-Executive Comm'n 2003 Report") at 24, attached as Exhibit 11.

23 State Dept. Report on Human Rights at 36, attached as Exhibit 10.

24 Id. at 35-36; Congressional-Executive Comm'n 2003 Report at 25, attached as Exhibit 11.

25 See State Dept. Report on Human Rights at 37, attached as Exhibit 10; Congressional-
(continued...)

southern China, workers continue to work hours substantially in excess of legal limits and for extremely low wages.[26] In many industries, compulsory overtime is common, often without overtime pay.[27] In fact, workers frequently are not paid even the paltry wages that they are due.[28]

The health and safety conditions in Chinese factories are also astoundingly poor and reflect the total lack of free bargaining between labor and management. According to conservative estimates, workplace accidents killed approximately 140,000 Chinese workers in 2002.[29] In addition, Chinese media sources reported 250,000 injuries and more than 30,000 deaths in workplace accidents in the first quarter of 2003 alone.[30] China has the dubious distinction of being ranked by the ILO as the world "leader" in industrial accidents.[31] Moreover, as recognized by the Congressional-Executive Commission on China,

> Migrant workers living in dormitories connected with factories in southern China often face conditions of severe overcrowding, lack of proper sanitation facilities, and inadequate fire and safety protection. Many have been denied medical care, access to schools for their children, and other social benefits.[32]

These dormitories also extend management control over workers beyond work hours and allow for near-total control over their lives.[33]

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25 (...continued)
Executive Comm'n 2003 Report at 26, attached as Exhibit 11.

26 Congressional-Executive Comm'n 2003 Report at 26, attached as Exhibit 11.

27 State Dept. Report on Human Rights at 37, attached as Exhibit 10.

28 "A 'Race to the Bottom' – Globalisation and China's labour standards," China Perspectives (March-April 2003) ("A Race to the Bottom"), at 46, attached as Exhibit 12.

29 Congressional-Executive Commission on China, Statement of Mil Niepold (Apr. 28, 2003), attached as Exhibit 13.

30 Id.

31 Id.

32 Congressional-Executive Commission on China 2002 Annual Report (Oct. 2, 2002) at 23, attached as Exhibit 14.

33 "A Race to the Bottom" at 46, attached as Exhibit 12.

Furthermore, forced labor in several different forms is common in China. Forced labor is an integral part of China's prison system whether the prisoner is detained for "re-education through labor" by administrative means without trial or forced to engage in labor while serving a formal criminal sentence. Chinese prison laborers are forced to work under conditions that violate China's own law and international labor standards.[34] But the *hukou*, or household registration, system in China is an even more egregious form of forced labor. Under the *hukou* system, all Chinese citizens are required to live and work in the place where they are permanently registered. The vast majority of Chinese citizens are registered in rural areas and, therefore, are unable to seek better-paying urban jobs without obtaining temporary residence and work permits required by the *hukou* system. However, to obtain these permits, they must pay substantial fees to government officials and employers. These fees result in heavy debt burdens that make it virtually impossible for the workers in question to change jobs. In addition, employers often take away the workers' permits, thereby precluding the workers from even attempting to seek another job. In short, the *hukou* system creates a system of forced labor.[35]

Finally, while Chinese authorities deny that child labor is a problem, there are strong indications to the contrary. Indeed, the Congressional-Executive Commission on China found in its 2003 Annual Report that "{c}hild labor continues to be a significant problem in China."[36]

In sum, labor conditions in China are among the worst in the world and clearly are not the product of free bargaining between labor and management.

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[34] Congressional-Executive Comm'n 2003 Report at 26-27, attached as Exhibit 11.

[35] See "A Race to the Bottom" at 44-47, attached as Exhibit 12.

[36] Congressional-Executive Comm'n 2003 Report at 23, attached as Exhibit 11.

IV. CHINA MAINTAINS SIGNIFICANT RESTRICTIONS ON FOREIGN DIRECT INVESTMENT

In assessing whether a foreign country has moved to a market economy, the Department must further examine the "extent to which joint ventures and other investments by firms of other foreign countries are permitted."[37] As the Department has recognized,

> Opening an economy to foreign investment tends to expose domestic industry to competition from market-based suppliers and the management, production and sales practices that they bring. It also tends to limit the scope and extent of government control over the market, since foreign investors, as a general rule, demand a certain degree of autonomous control over their investments.[38]

In evaluating this factor, the Department does not simply analyze whether the formal legal framework for foreign direct investment appears to be hospitable.[39] The Department must also evaluate "developments in the economy" to determine whether the country in question is truly open to foreign direct investment.[40]

While, on its face, China's economic system may appear to be conducive to foreign direct investment, the facts tell a different story. China receives far less foreign direct investment per capita than many other developing as well as developed countries. For example, in 2000, China received $30 per capita in foreign direct investment while Argentina received $315 per capita and OECD member countries received an average of $1,321 per capita.[41] Moreover, the OECD has

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37 19 U.S.C. § 1677(18)(B)(iii)(2001).

38 See Russia NME Memo at Analysis of Section 771(18)(B) Factors (Public Document); see also Romania NME Memo at 11 (Public Document) (same).

39 Memorandum from George Smolik to Faryar Shirzad, Assistant Secretary for Import Administration, Regarding Antidumping Duty Investigation of Silicomanganese from Kazakhstan – Request for Market Economy Status (Mar. 25, 2002) at Analysis of Section 771(18)(B) Factors (Public Document).

40 Id.

41 See "Attracting Investment to China," OECD Observer (Sept. 2003) ("Attracting Investment to China"), at 2, attached as Exhibit 15.

observed that its members "have so far provided a disproportionately small amount of foreign direct investment to China, at least partly because of perceived weaknesses in the legal and regulatory framework for investment."[42]

Indeed, the legislation governing foreign investment in China can be bewildering and often arbitrary, thereby posing enormous obstacles to entering the Chinese market. All foreign entities seeking to invest in China must get advance approval from the government.[43] Proposed projects are divided into four categories: encouraged, restricted, permitted, or prohibited.[44] China guides new foreign investment towards "encouraged" industries and regions. With respect to the "restricted" industries, a Chinese controlling or majority stake is typically required.[45] And for "prohibited" industries, such as traditional Chinese crafts and the futures industry, foreign direct investment is simply prohibited.[46] Chinese law also imposes strong barriers against foreign investors seeking to enter a local market through mergers and acquisitions.[47]

In addition, China's legal and regulatory system lacks transparency and consistent enforcement despite the promulgation of thousands of regulations, opinions, and notices affecting foreign investment.[48] According to the U.S. State Department, "{f}oreign investors continue to rank the inconsistent and arbitrary enforcement of regulations and the lack of transparency as two

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42 Id. at 3.

43 See "Country Commerce – China" at 23, attached as Exhibit 5.

44 Id. at 18; "Attracting Investment to China" at 5, attached as Exhibit 15.

45 "China Country Commercial Guide FY 2004," U.S. Commercial Service, U.S. Department of State (2004) ("China Country Commercial Guide"), at 67, attached as Exhibit 16.

46 "Attracting Investment to China" at 5, attached as Exhibit 15.

47 See "Country Commerce – China" at 26, attached as Exhibit 5.

48 "Country Commerce – China" at 8-9, attached as Exhibit 5; "China Country Commercial Guide" at 56, 81, attached as Exhibit 16.

major problems in China's investment climate."[49] Specifically, important new policies and rules in China are often treated as internal matters and are not made available to foreign firms.[50] The security of contracts is also a problem for foreign investors due to the maze of regulatory difficulties they face in trying to enforce contracts.[51] Furthermore, China still has failed to develop an impartial and effective court system.[52]

For all of these reasons, the legal and business environment in China continue to impose undue constraints on foreign direct investment.

V. THE MEANS OF PRODUCTION REMAIN SUBSTANTIALLY IN THE CONTROL OF THE CHINESE GOVERNMENT

In its NME analysis, the Department must examine "the extent of government ownership or control of the means of production."[53] As demonstrated below, the government continues to control much of the means of production in China, in particular through its ownership of large industrial companies.

Indeed, the U.S. State Department has recognized that "state-owned or state-controlled entities continue to play the leading role in the Chinese economy."[54] Traditional state-owned enterprises ("SOEs") and corporations with a majority of their shares held by the state still account for approximately 42% of China's annual gross industrial production.[55] Moreover, SOEs continue to generate over 50% of industrial value-added and employ more than half of the

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49 "China Country Commercial Guide" at 81, attached as Exhibit 16.

50 See id. at 56; "Country Commerce – China" at 8-9, attached as Exhibit 5.

51 See "Country Commerce – China" at 9, attached as Exhibit 5.

52 See "Attracting Investment to China" at 3, attached as Exhibit 15.

53 19 U.S.C. § 1677(18)(B)(iv)(2001).

54 "China Country Commercial Guide" at 8, attached as Exhibit 16.

55 Id.

industrial workforce. SOEs also control the bulk of productive assets in the industrial sector, holding two-thirds of the net fixed assets of all industrial enterprises in 2000.[56]

A substantial number of key sectors are wholly or mainly reserved to SOEs in China, including not only natural monopolies but also automobile and steel production. The Chinese authorities have indicated that they plan to reduce the role of SOEs to "strategic sectors," but they have not specified what those sectors will be.[57]

The financial performance of SOEs has been and continues to be woeful. Over half, or 51.2%, of China's 174,000 SOEs are loss-making.[58] Many are deep in the red. This weak financial performance is the product of numerous factors, including poor management, overstaffing, and high debt. The focus at China's SOEs is on jobs preservation, rather than the efficient use of capital.[59]

Notwithstanding the atrocious financial condition and performance of the SOEs, the assets of these entities have grown significantly in recent years. Indeed, the average asset size of centrally-administered SOEs has more than doubled since 1997.[60] Investment by state companies in fixed assets such as new plants and equipment increased by 26.7% in 2003 alone.[61] This

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56 "An Attempt to Profile the Finances of China's Enterprise Sector," International Monetary Fund (Nov. 2001) ("An Attempt to Profile the Finances of China's Enterprise Sector"), at 6-7, attached as Exhibit 17.

57 "China in the World Economy – The Domestic Policy Challenges," OECD (2002) ("China in the World Economy") at 48, attached as Exhibit 18.

58 "Management of China's State-Owned Enterprises Portfolio: Lessons from International Experience," World Bank (Sept. 3, 2003) ("Management of China's SOEs"), at i, 4, attached as Exhibit 19.

59 See id. at 11; "An Attempt to Profile the Finances of China's Enterprise Sector" at 4-5, attached as Exhibit 17; "Country Commerce - China" at 15-16, attached as Exhibit 5.

60 "Management of China's SOEs" at 2, attached as Exhibit 19.

61 "Country Commerce – China" at 9, attached as Exhibit 5.

increase in investment for the notoriously poor performing SOEs was made possible only through massive state subsidies.

These subsidies have taken two forms – government-directed financing through state-owned banks and debt-to-equity swaps. The government continues to intervene extensively to provide bank loans to prop up loss-making and often insolvent SOEs.[62] As a result, SOEs receive the bulk of the financing provided by the state-owned banks in China.[63] With respect to the debt-to-equity conversions, the government has established special state-owned asset-management companies to assume debt from the SOEs in return for an equity stake giving them influence over the management of the companies.[64]

State-owned steel producers in China have particularly benefitted from these massive state subsidies, which have, in turn, served to foster further state control and involvement in steel production. Such companies have received enormous amounts of low-interest financing from state-owned banks. Indeed, the steel industry has been one of the major recipients of government-directed loans from state-owned banks.[65] The American Iron and Steel Institute recently recognized that

> {l}ow-interest-rate financing continues to be a concern in China's steel industry. The government of China recently targeted six industries to receive interest-rate

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62 "China Country Commercial Guide" at 82, attached as Exhibit 16; Comments Submitted to the Interagency Trade Policy Staff Committee Regarding Review of China's Compliance with Its WTO Accession Commitments, National Association of Manufacturers (Sept. 10, 2003) ("NAM September 10, 2003 Comments"), at 3, attached as Exhibit 20; "China in the World Economy" at 18, 21, attached as Exhibit 18.

63 "China Country Commercial Guide" at 82, attached as Exhibit 16; "China in the World Economy" at 18, attached as Exhibit 18.

64 "Country Commerce – China" at 16, attached as Exhibit 5.

65 Record of the January 30, 2004 Hearing Conducted by the U.S.-China Economic and Security Review Commission on "China's Impact on the U.S. Manufacturing Base" (Mar. 4, 2004) ("U.S.-China Economic and Security Review Comm'n January 30, 2004 Transcript") at 73, attached as Exhibit 21.

subsidies, including steel, which was the largest recipient of the interest-rate subsidy. Both private and state-owned steel companies continue to have access to low-cost funds from state-owned banks that have a strong incentive to lend to a "designated industry" such as steel.[66]

The Chinese government has also undertaken a series of huge debt-to-equity swaps for state-owned steel producers. In 1999 and 2000 alone, debt-to-equity swaps brought $10.8 billion in debt relief to such producers.[67]

As a result of these mammoth subsidies provided by the Chinese government, the 65 steel SOEs in China were able to make approximately $6 billion in capital expansion expenditures in 2002.[68] Moreover, the Chinese steel industry has grown another 10% in the last 12 months.[69] Accordingly, the government's role in industrial production, particularly the steel industry, remains substantial and, in many respects, is growing.

In addition to its leading role in industrial production and the economy as a whole, the Chinese government remains a key actor in the land market. In fact, Chinese law provides that all land is owned by "the public," and individuals cannot own land.[70] Thus, all land is government-owned.[71]

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66 Written Statement for the Record of the American Iron and Steel Institute on United States-China Economic Relations Submitted to the House Committee on Ways and Means (Nov. 3, 2003) ("AISI Statement to the Ways and Means Committee") at 3, attached as Exhibit 22.

67 "China: Debt-to-Equity Swaps Help Steel Makers," China Daily (Mar. 26, 2000), attached as Exhibit 23; "China in the Global Economy – Reforming China's Enterprises," OECD (2000) ("China in the Global Economy"), at 78 n.3, attached as Exhibit 29.

68 AISI Statement to the Ways and Means Committee at 3, attached as Exhibit 22.

69 U.S.-China Economic and Security Review Comm'n January 30, 2004 Transcript at iii, attached as Exhibit 21.

70 "China Country Commercial Guide" at 79, attached as Exhibit 16.

71 Id.; "Country Commerce – China" at 31, attached as Exhibit 5.

Based on the foregoing, the evidence overwhelmingly indicates that the means of production remain substantially in the control of the Chinese government.

VI. THE CHINESE GOVERNMENT EXERTS SIGNIFICANT CONTROL OVER THE ALLOCATION OF RESOURCES AND PRICE AND OUTPUT DECISIONS OF ENTERPRISES

As yet another factor in its NME analysis, the Department must consider "the extent of government control over the allocation of resources and over the price and output decisions of enterprises."[72] As the Department has recognized, "{d}ecentralized economic decision-making is a hallmark of market economies, where the independent investment, input-sourcing, output and pricing actions of individuals and firms in pursuit of private gain collectively ensure that economic resources are allocated to their best (most efficient) use."[73] The Department has further determined that "{g}iven that banks are important allocators of capital, the degree to which the State exercises control over the commercial banking sector is an important consideration."[74] The Chinese government continues to exert significant control over the allocation of resources and price and output decisions of enterprises through a variety of direct and indirect means.

To begin with, China continues to control prices and output decisions to a significant extent. Although direct price controls on most commodities have been eliminated, the government continues to impose price controls on 13 broad categories of items, including electric power, transportation, telecommunications, and some services.[75] The temporary price floors imposed by the government in industries with excess capacity also act as price controls.[76]

72 19 U.S.C. §1677(18)(B)(v)(2001).

73 Romania NME Memo at 17 (Public Document).

74 Id.

75 "China Country Commercial Guide" at 8, attached as Exhibit 16; "Country Commerce – China" at 59, attached as Exhibit 5; "China in the World Economy" at 48, attached as Exhibit 18.

76 "China in the World Economy" at 48, attached as Exhibit 18.

There is an abundance of anecdotal evidence regarding the Chinese government's intervention in companies' decision making. For example, China's State Economic and Trade Commission continues to manage domestic steel production and export by setting "targets" for domestic production and export and formulating "operational guidelines" for China's steel industry each year.[77]

The Chinese government also controls the allocation of resources as well as pricing and output decisions through restrictions imposed on the import and export of various products. The government has restricted and continues to restrict imports through a vast array of licensing and quota regimes and through restrictions on the "trading rights" (i.e., the right to import and export goods) of companies in China, particularly foreign-owned and controlled companies.[78] Moreover, the government continues to impose export restraints on a number of products. In particular, European Union officials have recently complained of China's export restraints on coke, a raw material needed by steelmakers, and have threatened to launch an action at the World Trade Organization (the "WTO") to challenge such restraints.[79]

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77 Comments by the American Iron and Steel Institute on China's Compliance with WTO Commitments (Sept. 10, 2003) ("AISI September 10, 2003 Comments") at 7, attached as Exhibit 24; see also AISI Statement to the Ways and Means Committee at 3, attached as Exhibit 22 (expressing concern regarding the Chinese government's extensive intervention in the price-setting mechanism for steel).

78 See "Country Commerce – China" at 59, 86-87, attached as Exhibit 5; "China Country Commercial Guide" at 55-56, attached as Exhibit 16; NAM September 10, 2003 Comments at 5-6, attached as Exhibit 20; AISI September 10, 2003 Comments at 2-3, 6, attached as Exhibit 24; "2003 Report to Congress on China's WTO Compliance," Office of the U.S. Trade Representative (Dec. 11, 2003) ("USTR Report on China's WTO Compliance"), at 12-13, attached as Exhibit 25.

79 "Chinese Premier to Hear String of EU Trade Complaints in Brussels Today," Financial Times (May 6, 2004), at 7, attached as Exhibit 26; "EU Warns of Possible WTO Case on Chinese Coke Export Rules," Inside US-China Trade (May 12, 2004), at 8, attached as Exhibit 27.

The Chinese government also controls the allocation of resources and investment decisions by a variety of means. In the steel industry, for instance, the government has moved to halt investments, including ongoing construction of steel plants, that have not received the necessary permission from Beijing.[80]

But perhaps the strongest indication of the Chinese government's control over the allocation of resources and investment decisions is its overwhelming domination over the banking sector in China. Virtually all domestic financial institutions are state-owned, with only a single privately owned domestic bank, and there are no plans to relinquish state ownership of these institutions.[81] Indeed, the government has managed to keep out other banks by imposing working capital requirements and other requirements that are so burdensome and so far in excess of international standards that few banks can ever hope to meet them.[82] The four major state-owned commercial banks alone account for approximately three-quarters of domestic lending.[83] This complete control over the banking sector provides the Chinese government with unlimited means to control lending and investment decisions in China.

The Chinese government's complete control over the banking sector has resulted in a significant misallocation of resources. Specifically, despite their abysmal financial performance

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80 "Beijing Moves to Halt Illegal Projects," SteelWEEK (May 7, 2004), at 5, attached as Exhibit 28.

81 "China in the World Economy" at 19-20, attached as Exhibit 18; "China in the Global Economy" at 80, attached as Exhibit 29;

82 "Country Commerce – China" at 20, attached as Exhibit 5; "The U.S. Must Face Up to China's Trade Challenges," The Heritage Foundation (Oct. 23, 2003) at 6, attached as Exhibit 30.

83 "China in the World Economy" at 19-20, attached as Exhibit 18.

and condition, large SOEs continue to receive the bulk of commercial bank lending based on political, rather than commercial, considerations.[84] As the OECD recently concluded,

> credit is inefficiently allocated. SOEs receive the bulk of funds allocated by the formal financial system, while non-state enterprises receive a much lower share than warranted by their importance in the overall economy. Non-commercial considerations, such as the need to sustain loss-making SOEs, continue to influence bank lending.[85]

The most recent figures indicate that at least 80% of the loans of the major state banks, and nearly 75% of all commercial bank loans, are directed to SOEs. In contrast, less than 10% of such loans go to non-state enterprises.[86]

This practice by the Chinese government of using its control over the banking sector to keep loss-making SOEs afloat has taken a toll on China's financial system and, in turn, on the Chinese economy as a whole. The U.S. State Department recently found that "{a}uthoritative estimates of the total stock of bad debt in China's financial system range from <u>45 percent to 75 percent of the country's annual gross domestic product</u>."[87] In other words, while the government's practices have allowed many loss-making SOEs to survive, they have hindered the reallocation of resources to more efficient industries.

Clearly, the scope of the Chinese government's control over the allocation of resources and pricing and output decisions is enormous.

VII. OTHER FACTORS FOR THE DEPARTMENT TO CONSIDER

Finally, in making NME determinations, the Department is authorized to take into account "such other factors as . . . {it} considers appropriate."[88] In its request for comments here,

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[84] "China Country Commercial Guide" at 82, attached as Exhibit 16.

[85] "China in the World Economy" at 18, attached as Exhibit 18.

[86] "China in the Global Economy" at 80, attached as Exhibit 29.

[87] "China Country Commercial Guide" at 82 (emphasis added), attached as Exhibit 16.

[88] 19 U.S.C. § 1677(18)(B)(vi)(2001).

the Department has requested information regarding Chinese government policies and practices, including tax incentives and export promotion instruments, that appear to be inconsistent with the normal experience of a market economy and that have the potential to distort the market and U.S.-China trade.[89] In addition to the policies and practices discussed above, the Chinese government employs numerous incentive programs that are designed solely to favor domestic producers, restrict imports, and increase exports to the United States and other countries.

In particular, China applies its value-added tax ("VAT") in a manner that is clearly intended to favor domestic production and restrict imports in a number of industrial and agricultural sectors. For example, China provides a rebate of the VAT for all domestically produced semiconductors sold in China, but not for imported semiconductors.[90] The United States has recently challenged this practice at the WTO. The U.S. Trade Representative's Office has also found that China exempts domestically produced fertilizer from the VAT altogether.[91] Furthermore, as recognized by the Department, China uses the VAT to benefit its domestic steel industry as well. Indeed, under the Steel Import Substitution Program, Chinese steel producers receive a rebate of the VAT on sales to steel users that would otherwise import their steel needs.[92] In all of these respects, the Chinese government uses the VAT so as to promote the sale of domestically produced goods and to significantly restrict the sale of imported goods.

China also uses the VAT and other incentive programs to encourage companies to export their products to the greatest extent possible. Specifically, the Chinese government provides rebates of the 17% VAT for domestically-sourced goods that are used to produce items for

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89 Request for Comments on U.S.-China Joint Commission, 69 Fed. Reg. at 24133.

90 "USTR Report on China's WTO Compliance" at 7-8, attached as Exhibit 25.

91 Id.

92 "Report to the President: Global Steel Trade – Structural Problems and Future Solutions," U.S. Department of Commerce (July 2000), at 154, attached as Exhibit 31.

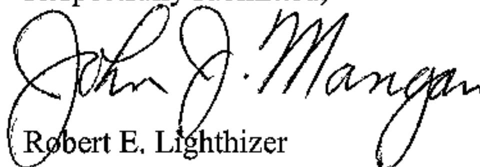
export.[93] Moreover, the central and provincial governments in China continue to provide other direct and indirect subsidies to companies engaged solely or primarily in export operations.[94]

Accordingly, China uses the VAT and other incentive programs to provide a substantial benefit to its domestic producers and to companies engaged in export operations. These programs certainly operate to distort the Chinese market and U.S.-China trade.

VIII. CONCLUSION

As demonstrated above, the overwhelming weight of evidence shows that China exhibits none of the characteristics of a market economy. To find otherwise would be to ignore the studied conclusions of all parties who have analyzed the situation, including the U.S. Government itself. The Department should address the critical issues identified above in its upcoming discussions with the Chinese government and should find that China must make radical changes and developments before its NME status may be reconsidered.

Respectfully submitted,



Robert E. Lighthizer
John J. Mangan
Jeffrey D. Gerrish

On Behalf of United States
Steel Corporation

93 "China Country Commercial Guide" at 54, attached as Exhibit 16; AISI September 10, 2003 Comments at 3, attached as Exhibit 24.

94 "Country Commerce – China" at 45, attached as Exhibit 5; AISI September 10, 2003 Comments at 3-4, attached as Exhibit 24.

Exhibit 1

NEWSROOM

American Jobs American Values
U.S. Department of Commerce

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FOR IMMEDIATE RELEASE
Wednesday , April 28, 2004

STATEMENT FROM COMMERCE SECRETARY DONALD L. EVANS ON AMERICA'S ECONOMIC RELATIONSHIP WITH CHINA

"The tool that we have to press China to reform its labor standards is the designation of China as a market economy under the U.S. trade laws. As Secretary of Commerce, I'm charged with determining whether or not China meets the definition of a market economy.

"We all know that obtaining market economy status is a high priority for the Chinese leadership. Without this status, China is subject to more antidumping cases with higher duties on their imports.

"To be designated a "market economy," countries must meet the six criteria spelled out by the Tariff Act of 1930. Labor standards and currency are two of the six criteria. In other words, China will be required to reform its labor standards and its currency policies before it can be granted market economy status.

"Last week, the U.S. and China agreed to an unprecedented dialogue to tackle these issues head-on. We've established a Structural Working Group so that China will hear, directly from me, exactly what steps they must take to satisfy the law. And the law is clear: China will fail to meet Market Economy status until market forces set labor and currency rates.

Until these reforms are made – and the statutory criteria are met -

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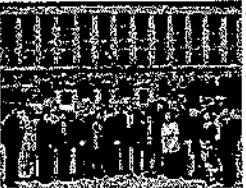

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China will continue to be considered a non-market economy under U.S. anti-dumping law, and American companies alleging unfair trade practices are generally more likely to be successful.

"But our goal isn't to impose dumping actions. We're not about petitions--we're about results. Our goal is to ensure that American companies compete on a level playing field.

Promoting economic engagement--not economic isolation--is the best way to raise labor standards and living standards in China.

"As Secretary of Commerce, I'm also focused on expanding U.S. exports to China, our fastest growing market. And we've seen tremendous results. Our exports to China have grown 76% during this Administration. During the first two months of 2004, exports to China are up 39% year-over-year. That means good, high-paying American jobs depend on trade with China. But the rapid progress in our export promotion efforts within the Chinese market would be jeopardized by a blunt instrument like this petition.

"Let's continue to use the most effective tools at our disposal-the bilateral dialogue with the Chinese on market economy status at the Structural Working Group-to leverage change in China. Here's the bottom line: Until market forces set economic decisions – including labor and currency rates, China will remain a non-market economy."

US Department of Commerce, 1401 Constitution Avenue, NW, Washington, DC 20230
Last Updated: April 28, 2004 2:04 PM

Contact Secretary Evans by email at devans@doc.gov.
Direct inquiries about this page to webmaster@doc.gov.

Privacy Policy

Exhibit 2

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

October 30, 2003
JS-956

Economic Relations between the United States and China and China's Role in the Global Economy
John B. Taylor
Under Secretary of Treasury for International Affairs
Committee on Ways and Means
October 30, 2003

Chairman Thomas, Ranking Member Rangel, Members of the Committee, thank you for giving me the opportunity to testify on economic relations between the United States and China and on China's role in the global economy.

International Economic Strategy

Our economic relations with China are an important part of our overall economic strategy. The goal of that strategy is to strengthen the current economic recovery and establish conditions that will lead to a long economic expansion in the United States. The economic expansions of the 1980s and the 1990s were the first and second longest peacetime expansions in American history, and with the right policies there is no reason to expect that the current expansion will not be as long or longer. The Jobs and Growth package enacted into law this summer, is an essential part of the policy, as are the President's proposals for tort reform, regulatory reform, and health care reform.

But even with these policy reforms in the United States there are barriers to economic growth in other countries. And these barriers have ramifications for economic growth in the United States. This is why the international component of our economic strategy is so important.

The strategy has been to urge the removal of rigidities and barriers wherever they exist, and to encourage pro-growth and pro-stability policies that benefit the United States and the whole world. The international strategy is built on bilateral economic relationships, including, of course, our relationship with China. It also has a multilateral foundation, including the meetings of groups such as the G-20, where China is included, or the newly established talks between economic officials from China and the G-7.

Global Economic Recovery

Thanks to the recent fiscal and monetary policy actions, the United States economy is now expanding much more rapidly. Consumer spending is growing at a very strong pace, housing remains solid, and business investment is picking up. The latest data also show exports to be gaining strength compared with the first half of the year. The September employment data showed a promising increase in jobs as well.

Global growth is also improving. There is continuing evidence of stronger economic growth in the Japan, Canada, and the United Kingdom. An increase in business and consumer confidence in the Euro area is a welcome sign that economic recovery is on the way there too. Much of Asia seems to have bounded back from the SARS induced slowdown in the first part of the year. Growth in China recovered sharply in the third quarter following a decline in the second quarter. Growth in other emerging markets is also picking up as the number of crises is down, capital flows are up, and interest rate spreads are low compared with the late 1990s

Pressing Ahead on the Global Economic Expansion

Despite this progress, we need to do more. Last month the G7 launched a new Agenda for Growth. For the first time each G7 country will take part in a process of benchmarking and reporting actions to spur growth and create jobs. Another example is the new United States-Brazil Group for Growth through which we will work together to identify pro-growth strategies at the micro as well as macro levels. Exchange rate policy also has bearing on growth and stability. Earlier today the Treasury issued its latest Report on International Economic and Exchange Rate Policies. This report examines exchange rate policies in major countries around the world. The Report reiterated our view that flexible exchange rates are desirable for large economies. However, the report documents that a number of countries continued to use pegged exchange rates and/or to intervene substantially in the foreign exchange market. The Administration strongly believes that a system of flexible, market-based exchange rates is best for major economies. For this reason, the Bush Administration is aggressively encouraging our major trading partners to adopt policies that promote flexible market-based exchange rates combined with a clear price stability goal and a transparent system for adjusting the policy instruments.

The move by several large emerging market countries—such as Brazil, Korea, and Mexico—to flexible exchange rates combined with clear price stability goals and a transparent system for adjusting the policy instruments is one of the reasons we are seeing fewer crises and greater stability. We emphasize that the choice of an exchange rate regime is one where country ownership is particularly important. We also recognize that, especially in the case of small open economies, there are benefits from a "hard" exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria.

The Economy of China and its Links to the United States and the Global Economy

Let me now address China's economy. Economic reforms in China have increased economic growth and transformed China into a major economy in the world, both in terms of total production and in terms of purchases and sales of goods with the rest of the world. Yet, with per capita income of only about $1,000 per year and with financial, legal and regulatory systems in need of reform, China still faces challenges in its effort to catch up with developed economies.

China's global current account surplus was under 3 percent of GDP in 2002 and declined to 1.8 percent in the first half of 2003. Despite the relatively small overall surplus, China has a large trade surplus with the United States. This means, of course, that China has a large deficit with the rest of the world. China's bilateral trade surplus with the United States was $103 billion in 2002 while China's trade deficit with the rest of the world was about $73 billion, leaving an overall surplus of $30 billion. Many imports from China are goods from other Asian economies that are processed or finished off in China before shipping to the United States and other countries. Other East Asian economies increasingly send goods to China for final processing before they are shipped to the United States. China accounted for 11 percent of U.S. imports in 2002, up from 3 percent in 1990. Meanwhile, the combined share of Japan, Korea and Taiwan in U.S. imports declined to 17 percent from 27 percent over the same period. Thus, the total share of U.S. imports coming from these four Asian countries has remained steady since 1990, actually falling slightly from 30 percent to 29 percent.

U.S. imports from China are about 1 percent of U.S. GDP, or 11 percent of total U.S. imports. U.S. imports from China have been increasing rapidly, between 20 and 25 percent in 2002 and 2003. In general, these imports result from China using low-skilled labor to assemble and process imported parts and materials originating in other countries-mostly from other Asian countries that have traditionally exported directly to the United States. Consequently, the share of U.S. imports from these other countries has declined just as China's share has increased. Asia's share of U.S. imports has declined slightly. Much of the increase in U.S. imports from China

has come at the expense of imports that once came directly from other Asian countries.

At the same time, U.S. merchandise exports to China grew 21 percent in the first 8 months of this year. Growth has been especially rapid in recent years for U.S. exports to China of transportation equipment (including aircraft engines), machinery, chemicals, and semiconductors.

The U.S. trade deficit with China should be viewed in the context of the overall trade deficit of the United States. The U.S. trade deficit is spread across many countries of the world in addition to China. For instance, the overall trade deficit reached $468 billion last year with 1) the Americas accounting for $105 billion, 2) Western Europe $89 billion, 3) Japan $70 billion, and 4) China $103 billion. The U.S. overall trade and current account deficit is best understood in terms of the gap between investment and saving in the United States. If this gap were reduced through an increment in savings, the overall deficit could shrink as would the size of the bilateral deficits. Increased growth abroad is also crucial to increasing U.S. exports.

China's Exchange Rate Regime

For nearly ten years now, the Chinese have maintained a fixed exchange rate for their currency relative to the dollar. The rate has been pegged at about 8.28 yuan/dollar for the entire period. Thus, as the dollar has appreciated or depreciated in value relative to other currencies, such as the euro or the yen, the yuan has appreciated or depreciated by the same amount relative to these other countries.

To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market. It sells yuan in exchange for dollar denominated assets when the demand for the yuan increases and it buys yuan with dollar denominated assets when the demand for the yuan decreases. Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by $171 billion to $384 billion (as of end-September).

This accumulation of foreign exchange reserves would tend to expand China's money supply, although in recent months the Chinese central bank has moved to reign in monetary expansion. Among other measures to sterilize reserve accumulation, the central bank has—for the first time—begun issuing central bank paper to restrict growth of the monetary base. Nevertheless, the broader money supply continues to grow very rapidly: M2 climbed 21 percent over the 12 months ending in September 2003.
It is also important to recognize that China still has significant capital controls. China's capital controls allow for more inflows than outflows, thus bolstering foreign exchange reserves. China is gradually loosening some controls, and outflows are likely to grow as new channels develop for Chinese to seek diversification and better returns than those offered by low domestic interest rates. Indeed, there is already significant leakage of capital. A relaxation of controls on outflows would reduce upward pressure on the yuan.

Economic Relations between the United States and China

With its rapid growth and substantial foreign exchange reserves, China is now in a position to show leadership on the important global issue of exchange rate flexibility. China represents one of the largest economies in the world, and a flexible exchange rate regime would be a good policy for China. It would allow China to open the nation to capital flows and reduce macroeconomic imbalances. We have been urging China to move to a flexible exchange rate.

We have also urged the Chinese to move forward in two other areas: reductions in barriers to trade and capital flows. In the area of trade, it is important for China to fully implement, and even surpass, the commitments it made to the World Trade Organization. It is important that China continue to open markets to U.S. services,

agricultural and industrial products, and to effectively enforce intellectual property laws.

China's restrictions on capital flows are one of the major rigidities interfering with market forces. The authorities understand this and are beginning to reduce barriers to capital flows and develop more open and sophisticated capital markets. They are also working to strengthen the banking system and liberalize capital flows in order to prepare for a more flexible exchange rate.
Secretary Snow traveled to Beijing last month to urge further progress. He met Premier Wen, Vice Premier Huang, Central Bank Governor Zhou, and Finance Minister Jin. He met again with the Finance Minister and Central Bank Governor last week in Mexico.

President Bush recently met with President Hu. He discussed each of these economic issues. He stressed the importance of reducing barriers to trade, of removing restrictions on the transfer of capital, and of moving to a flexible, market-based, exchange rate. Recently, both Secretary Evans and US Trade Representative Robert Zoellick traveled to China to stress the importance market opening, especially in the area of trade in goods and services. In an important recent development, Vice Premier Huang has accepted an invitation to come to the United States to engage in high-level talks with Secretary Snow.

All of Secretary Snow's meetings have been detailed and candid. He stated publicly, "the establishment of flexible exchange rates, of a flexible exchange rate regime, would benefit both our nations as well as our regional and global trading partners." The Chinese reported that they intend to move to a market-based flexible exchange rate as they open the capital account. The central bank governor stated publicly that reform of the exchange rate regime is a central part of their foreign exchange reforms.

Secretary Snow's visit to Beijing achieved significant progress, including new policy announcements by China's central bank; liberalized regulations for foreign firms managing their foreign exchange; and significantly liberalized provisions to allow Chinese travelers to take foreign currency out of the country and to do so more frequently. The United States will continue to urge the Chinese to make rapid progress in these areas.

We intend to continue both technical work and high-level talks and on this subject. We have just established a United States-China Technical Cooperation Program in the financial area that will help China develop its financial market infrastructure, including the foreign exchange market.
The Chinese and the G7 agreed to engage in talks about these economic issues. This represents another example of how China, the United States and other affected parties can come together to work on an issue of vital interest to them all. The first meeting between senior officials from the G-7 and China's finance ministry and central bank took place in September in Dubai, where the Chinese economy, the G7 economies, and other economic issues, were discussed. Further meetings will be scheduled on a regular basis with China, the United States and the other G7 countries. After the Dubai meeting, China's central bank representative said that China is moving as fast as it can in its reform.

Conclusion

I am pleased to report that our economic strategy is showing progress: global economic growth is accelerating, led by an even stronger acceleration of economic growth in the United States. Our efforts to engage in financial diplomacy are generating constructive responses, though much more needs to be done. Active engagement with China and other countries is paving the way toward freer markets. The Administration's effort to raise growth in the United States and abroad, and thereby create jobs at home is succeeding.

Exhibit 3

JULY 2002 - REPORT TO CONGRESS OF THE U.S. - CHINA SECURITY REVIEW COMMISSION - THE NATIONAL SECURITY IMPLICATIONS OF THE ECONOMIC RELATIONSHIP BETWEEN THE UNITED STATES AND CHINA

Chapter 2 - Trade and Investment

Key Findings

- With a virtually inexhaustible supply of low-cost labor and large inflows of foreign direct investment (FDI) accompanied by transferred manufacturing facilities and technologies, China has positioned itself as a global export platform. China runs trade surpluses with most of the industrialized world and has been the recipient of transplanted manufacturing capabilities from the United States, the European Union, Japan, and Taiwan, among others.

- The United States has been a major contributor to China's rise as an economic power. As China's largest export market and a key investor in the Chinese economy, the United States has helped China become a global manufacturing center and an increasingly important center for research and development (R&D). The result of this trade and investment has enabled China to accumulate large U.S. dollar reserves. In addition, U.S. universities, laboratories, and industries have trained many thousands of Chinese scientists who have aided in a massive transfer of technology and know-how to China.

- The United States trade deficit with China is not only our largest deficit in absolute terms, but it is the most imbalanced trading relationship the U.S. maintains. In 2000, U.S. trade with China was only 6 percent of total two-way U.S. goods trade, but the U.S. deficit with China accounted for 19 percent of the total U.S. trade deficit. U.S. imports from China were over 41 percent of China's total exports, but U.S. exports to China were only 2 percent of total U.S. exports to the world. Both the EU and Japan import much less from and export much more to China than does the United States. Some U.S. exports are lost due to China's politicization of trade. The Commission finds there is plausible evidence that the burgeoning trade deficit with China will worsen regardless of China's entry into the World Trade Organization (WTO).

- During the 1990s, the U.S. trade deficit with China grew to alarming proportions — from $11.5 billion in 1990 to $83 billion in 2001. Most U.S. imports from China over the past decade have been the product of low-skilled, labor-intensive manufacturing industries. However, this trend has begun to shift rapidly -- China's exports of advanced technology products (ATP) to the United States have sky rocketed from virtually zero in 1990 to $13.3 billion in 2001. The United States is now running a trade deficit with China in a majority of the items on the ATP list compiled by the Commerce Department. The U.S. Government's ability to identify vulnerabilities and dependencies of our military-industrial base is complicated by global supply chains and limited by insufficient data. The Commission is concerned that the United States may be developing a reliance on Chinese imports that might in time undermine the U.S. defense industrial base.

- U.S. FDI into China has resulted in increased foreign affiliate sales in the Chinese market and increased related party imports back into the U.S. market. Globalization has increased the trend towards subcontractors outsourcing key components and multinational companies utilizing China as an "export platform". Over 90 percent of the FDI attracted to the U.S. was for the purpose of acquiring ownership of existing U.S. businesses. The opposite is true for FDI flows into China where estimates indicate that 90 percent of FDI is destined to establish new operations. In short, U.S. capital and Chinese labor are manufacturing products in China for both the Chinese and American markets. U.S. manufacturing workers are increasingly displaced.

- Investment in R&D has been a growing component of U.S. investment agreements with China. There has not been adequate U.S. Government oversight or analysis of these investments and their impact on U.S. economic and national security interests.

- Under the WTO, China has agreed not to condition investment or import approvals on performance requirements, including transfer of technology or requirements to conduct research and development in China. China's full compliance with these obligations is in the U.S. national security interest.

- Over the past decade, China's import and investment policies have promoted technological modernization in their industrial and military sectors. The United States has been a key target of China's efforts.

- China is a conspicuous abuser of human rights, labor rights and the environment and its refusal to follow international standards in these and other areas gives them an unfair competitive advantage vis-à-vis U.S. workers and businesses.

- Continuing trade surpluses, vast investment inflows, and very high foreign exchange reserves are evidence that China is manipulating its currency by holding down its value thereby gaining an unfair trade advantage that increases the U.S. trade deficit.

- The State Department has informed the Commission that the large number of Chinese students, scholars, and researchers present in the U.S. academic and industrial establishment is a principal means used by China to acquire U.S. science and technology. The U.S. Government has limited knowledge of their number, backgrounds, and activities.

Introduction

Over the past two decades, China has emerged as a major participant in the international economy. China's two-way international goods trade grew from roughly $28 billion in 1982 to $510 billion in 2001. In 2000, Mainland China was the world's seventh largest goods exporter ($249.3 billion) and eighth largest importer ($225.1 billion).[1] During the mid- to late 1990s, China became one of the world's largest recipients of foreign direct investment (FDI). According to Chinese statistics, FDI flow into China in 2001 was a record $46.8 billion. To accomplish such sustained growth in exports and investment over the past decade, China's leadership targeted technological modernization as the main pillar for such growth and steered the country's trade and investment policies to support that objective.

The importance of the United States to China's economic growth during the past decade cannot be overstated. The United States is China's biggest export market, a key investor in its economy, and a principal source of technology and know-how. Since trade relations resumed in 1978, overall U.S. trade with China has grown from $1 billion to $119.5 billion in 2000. From 1990 to 2000, the U.S. direct investment position in China grew from $354 million to $9.58 billion, according to U.S. Government figures. The U.S. capital markets have also been an important source of capital: the Chinese have raised approximately $20 billion dollars over the past three years.[2]

Unfortunately, the U.S. role in China's economic growth has some negative implications for the U.S. economy. From 1990 to 2000, the U.S. goods trade deficit with China grew seven-fold from $11.5 billion to $87 billion and surpassed Japan as our largest trade deficit. Such an imbalanced relationship has troubling implications for U.S. jobs and wages, as well as for the overall economic health of the U.S. manufacturing sector.

In this chapter the Commission details the uniqueness and causes of the U.S. trade deficit with China and describes the shifting composition of China's trade toward higher technology goods. We also examine the impact of U.S. investment on China's economic growth and technological modernization. The chapter ends with the Commission's assessment of the national security implications of these developments and recommendations in key areas.

U.S.-China Trade

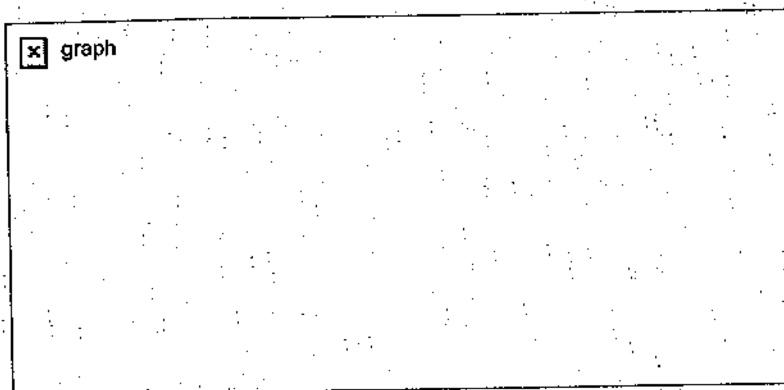
China has had one of the world's fastest growing economies and has shown substantial export prowess across a wide range of goods. In just the past ten years, China has experienced rapid growth in its goods trade, with total value soaring from around $100 billion in 1990 to nearly $510 billion in 2001. China's worldwide exports outpaced imports for all but one of those years (1993), generating annual world-wide trade surpluses, albeit not huge ones.

The U.S. Trade Deficit with China - The United States has played a significant role in helping China's export-led growth policies succeed in a way that is not evidenced by China's other trading relationships. The U.S. consumer goods market was the cornerstone for China's growth in trade in the 1990s. As trade between the United States

and China expanded, so too did the U.S. trade deficit. The growth of U.S. imports from China has far exceeded the growth in our exports to China. According to WTO data, in 2000, the United States took 41.3 percent of China's total exports, while China purchased about 2 percent of total U.S. exports. From 1990 to 2000, U.S. exports to China increased from $4.8 billion to $16 billion, while imports from China leaped six-fold from $16.3 billion to $103 billion. The result has been a U.S. goods trade deficit with China that has ballooned from approximately $6 billion in 1989 to $87 billion in 2000. Notably, U.S.-China trade in manufactures accounts for virtually the entire U.S. trade deficit with China.[3]

Figure 2.1

United States Trade with China 1990-2001



Source: USITC Dataweb

The U.S. trade deficit with China is not only the largest in absolute terms, but trade with China is also the most imbalanced trade relationship the United States has with any of its major trading partners:

Figure 2.2

Comparison of U.S. Trade with China and Other Trading Partners: Import/Export Ratios

	1997		1998		1999		2000		2001	
	Imp:Exp Ratio	Value (US$b)	Imp:Exp Ratio	Value (US$b)	Imp:Exp Ratio	Value (US$b)	Imp:Exp Ratio	Value (US$b)	Imp:Exp Ratio	Value (US$b)
China	4.88	75.34	4.99	85.41	6.23	94.90	6.16	116.32	5.32	121.52
Canada	1.12	318.17	1.13	329.00	1.21	362.24	1.30	405.64	1.33	380.69
Mexico	1.20	157.25	1.20	173.72	1.26	196.75	1.22	247.63	1.29	232.94
EU — 15	1.12	298.45	1.18	325.87	1.29	347.01	1.34	385.19	1.38	379.21
Japan	1.85	187.03	2.11	179.87	2.29	188.89	2.25	211.83	2.20	184.24

Source: USITC Dataweb and Commission calculations.

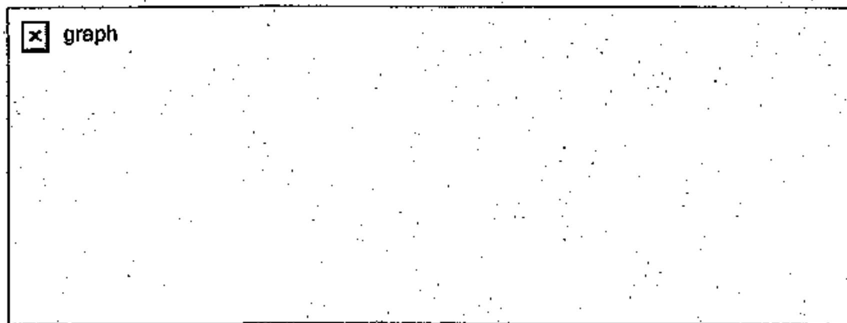
Trade with China represents only 6.5 percent of U.S. worldwide trade, but accounts for approximately 20 percent

of the U.S. global trade deficit. As shown above, in 2001, the ratio of imports to exports in trade with China was 5.32 to 1, as compared to a ratio of 2.2 to 1 with Japan and 1.38 to 1 with the European Unition (E.U.).

Together the United States, E.U., and Japan received about 88 percent of China's total exports in 2000, and took over 90 percent their exports in manufactured goods. However, Japan and Europe imported less from and exported more to China than did the United States. The most striking feature of U.S. exports to China is that the United States competes directly with both Japan and the E.U. and frequently comes in a distant third. In both the aggregate and at sectoral levels, the U.S. is selling less to China. Particularly stark are the relatively small U.S. sales of manufactured goods. The exceptions are aircraft and fertilizers, where U.S. sales are greater than its competitors. The skewed trading relationship raises questions not only of competitiveness, but also whether China is managing or politicizing aspects of its trading relationships.

Figure 2.3

China's Imports from its Major Trading Partners: U.S., E.U., JAPAN 1990-2000



Source: China Statistical Yearbook, various issues; compiled by USCC

Japan's Trade Deficit with China - Japan's trade deficit with China was $24.7 billion in 2000; Japan exported $30.4 billion and imported $55.1 billion. In general, the Japanese are more successful in selling to China across a broader range of manufactures categories. As a result, Japan has the highest exports to China among the three major trading partners. Japan dominates markets for many products that it exports to China. Japan sells more iron and steel, fabric and fibers, and chemicals than the E.U. or the United States. Additionally, the Japanese sales of electrical machinery and machinery, which are mostly components for assembly and re-export, have been higher than U.S. sales in these sectors.

The European Union's Trade Deficit with China - The E.U. trade deficit with China was $33.4 billion in 2000; the E.U. exported $27.8 billion and imported $61.2 billion. The E.U. is selling more pharmaceutical products than either Japan or the United States does to China. The E.U., like Japan, also exports more vehicles, vehicle parts, machinery, and electrical machinery to China than does the United States.

Factors Contributing to the U.S. Deficit with China

Openness of the U.S. Market — Along with more open markets than the EU or Japan to foreign imports of many consumer goods, the U.S. has a more highly developed distribution network for imports. Significantly, a sizeable portion of U.S. imports from China is comprised of shipments to U.S. companies from their affiliates in China or from their China-based subcontractors. Increasingly, U.S. multinationals are utilizing China as an export platform in order to compete more aggressively in the global economy. While it is difficult to obtain precise figures for imports that U.S. retailers have subcontracted, there is no doubt that large U.S. retailers make up a significant portion of the import market. For example, news reports indicate that American retailer Wal-Mart alone imported over $10 billion worth of Chinese goods in 2001, equivalent to around 10 percent of total U.S. goods imports from China for that year.[4]

Comparative Advantage - U.S.-based companies may have difficulties competing in the U.S. market with some Chinese imports due to China's low-cost labor. The Commission underscores that China's cost advantage is in

part due to the country's lack of government restrictions on environmentally damaging commercial activities and the Chinese government's repression of civil organizations, trade unions, and other political and human rights.

Investment and China's Rise as an Exporting Platform - Throughout the 1990s, FDI flows into China, which have been primarily concentrated in the manufacturing sector, helped China become a world center for manufacturing and continue to have a significant impact on China's export-led growth. The Commission has reviewed a study reporting that over 90 percent of FDI into China was for the establishment of new businesses, while over 90 percent of the FDI into the United States was for acquisition of existing U.S. businesses.[5]

The share of exports to the United States produced by foreign-invested firms has steadily increased over the last decade and a half. China required export performance as part of its investment agreements with foreign firms. In 1985, foreign-invested firms produced 1percent of China's exports. In 1990, they produced 12.5 percent, and in 2000 48 percent.[6] Researchers at the New York Federal Reserve Bank estimate that only 20 percent of China's total imports reach China's domestic markets, while the other 80 percent consist of capital goods and industrial inputs used for the country's exporting zones.[7] Morgan Stanley's most recent report on the U.S. deficit with China described, the contribution of foreign enterprises to China's export ascendancy as "nothing short of staggering".[8] China reported a new record in FDI actually absorbed for 2001 of $46.8 billion and expects to attract over $50 billion in new FDI in 2002, with much of the new FDI focused on high-tech sectors.[9] Just as investment in labor-intensive industries drove a dramatic rise in China's exports in those sectors, there is a high probability that increasing investment in advanced sectors will cause exports in the higher value-added goods to continue to rise dramatically.

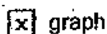
Also, contributing to the expanding U.S. trade deficit with China is the shifting composition of the U.S. trade deficit with Asian nations.[10] In many instances, U.S. imports from China displaced low-cost goods from other Asian countries. As Chinese goods put price pressures on the labor-intensive manufactured goods from the newly industrialized countries of Asia in the early 1990s, these countries were compelled to move up the quality and value-added ladder into goods like advanced personal and professional electronics and computer-related hardware. By 2000, all of the Asian Tigers, and even Japan, began to see many of their manufacturers migrate to China where they could sell in China but also use it as an export platform to the U.S. The Commission believes this trend is important to note, and in Chapter 5 we have assessed it in greater depth.

In part, the U.S. trade deficit with China represents a shift in trading patterns between the U.S. and Asia as a whole. Many of the Asian nations have shifted some of their production to China to take advantage of the comparatively lower cost-of-production. U.S. imports from China have displaced some of the imports from these nations. The U.S. trade deficit with China accounted for 20 percent of our deficit with the Asian region in 1992, and doubled to 40 percent by 2001. The U.S. trade deficit with the entire Asian region also continued to grow during this same time period from $91.7 billion to $212.5 billion.

U.S. Investment and Growth of Related Party Trade — Running counter to the traditional trade policy view that investment leads to trade, the increasing amounts of investment into China by U.S. firms appear to be contributing to the widening U.S. trade deficit. Many U.S. companies make products in China and then export them back to the U.S. or export them to other countries (thereby displacing U.S. exports to those countries). Related party trade (trade between a company and its foreign affiliate) as a subcomponent of U.S.-China trade has grown dramatically. According to U.S. Department of Commerce data, around 18 percent of U.S. imports from China in 2000 came from related parties, a number that has steadily risen over the past decade. For example, as reported in a Xinhua News Agency dispatch this year: "Motorola has opened eight joint-ventures in China, a $3.4 billion investment. These joint-ventures exported over $1 billion worth of goods last year, making Motorola the largest exporter among China's foreign-invested firms."[11] Motorola plans to increase its total investment in China to $10 billion by 2006[12]. As Motorola's investments and production in China have increased, it has reduced employment at its U.S. facilities.

Figure 2.4

U.S. Imports from China (1992-2000)


graph

Source: USITC Dataweb, U.S. Bureau of Economic Analysis; compiled by USCC Staff

Percentage of Imports due to Related Party Trade

Lack of Market Access to China - In part, the U.S. trade deficit with China results from a market that has been relatively closed to U.S. goods through restrictive tariff and non-tariff trade policies, as well as the politicization of its trade policies. China has closely guided its import policies to support its growth objectives. Despite attempts throughout the 1990s by the U.S. and other foreign governments to gain greater market access in China for their domestically produced goods, much of China's imports have been inputs for assembly and re-export. Although China reduced tariffs from an average of 43 percent in 1994 to an average of 15 percent by the end of 2001, the government and state-owned enterprises sought protection through a series of non-tariff barriers targeted at imports not related to re-export trade. As one witness told the Commission: "(O)f even greater significance to our trade deficit with China are the costly and burdensome non-tariff barriers which confront our companies. These barriers take many forms, from a distribution system which discriminates against our companies, to the discriminatory buying practices of state-owned enterprises, to the arbitrary customs procedures we face at the ports-of-entry."[13]

The United States, as well as China's other major trading partners, supported China's entry into the WTO in part to address the non-tariff barriers and trade-distorting practices of the Chinese government and state-owned entities, with the goal of enhancing market access for their goods. But, there is no indication that China's accession to the WTO will significantly reduce the burgeoning U.S. trade deficit with China.[14] In testimony before the Commission, representatives of the Bush Administration made clear that reduction of the U.S. trade deficit with China was *not* a necessary objective of China's accession. Assistant Secretary of Commerce William Lash stated:

> *[T]he 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.*[15]

Currency Manipulation - The exchange rate of the Chinese yuan (or *Renminbi*) to the dollar is also an important contributing factor to the U.S. deficit. While the United States has a free-floating exchange rate in which official intervention is both rare and done in small amounts, China holds a soft peg to the dollar with its currency nonconvertible on the capital account. In 2001, despite the country's $23 billion global trade surplus and FDI inflow of $46.8 billion, China maintained its soft peg. China accomplishes this through large official purchases of dollars in order to maintain an exchange rate lower than would otherwise occur by market forces alone. By holding down the exchange rate, China gains an unfair trade advantage that increases the U.S. trade deficit beyond what the market would dictate. Ernest H. Preeg, Senior Fellow in Trade and Productivity at the Manufacturers Alliance/MAPI, who testified before the Commission in May 2001, wrote in his testimony to the Senate Banking Committee in May 2002:

> *Based on the IMF definition, China has clearly been manipulating its currency for mercantilist purposes. The Bank of China has made protracted large scale purchases of foreign exchange- $150 billion since 1995- in order to maintain a large trade surplus as an offset to poor growth performance in the domestic [Chinese] economy.*[16]

C. Fred Bergsten, Director of the Institute for International Economics, has also advocated pressuring China to change its exchange system. "Because of the exchange controls, they require the export earnings of a Chinese exporter to be sold to the central bank for local currency...I'm proposing that we suggest they not do it...The implication would then be an appreciation of the Renminbi and some modest depreciation of the dollar." The Commission believes China's currency manipulation needs to be addressed and that the Chinese should be pressured to change their exchange rate policy and eliminate capital controls. Moreover, while it is not presently in China's interest to use its very large dollar reserves as an economic weapon against the U.S., in the future, this possibility exists. The Commission will continue to monitor this issue.

China's Growth in the Export of Advanced Technology Products

The bulk of U.S. imports from China over the past decade have been labor-intensive and low-skilled assembly manufactured products. While these products still dominate U.S.-China trade and the absolute size of China's surplus in this area is growing dramatically, the composition is shifting.[18] China is now also exporting to the U.S. higher value-added manufactured goods and an increasing amount now qualify as Advanced Technology Products (ATP).[19] A Commission study has found that China's rapid technological and economic success and its unique overall trading relationship with the U.S. is a strong, contributing factor to China's shift toward exporting more ATP goods.[20]

Global ATP trade has historically been one of the areas of U.S. strength, even as manufactured goods trade fell to record deficits during the past decade. However, the export advantage that the U.S. enjoyed in ATP trade with China in 1990 was lost by 1995, and the U.S. has seen a general trend of broadening and deepening ATP deficits with China every year since. In less than a decade, China, in its trade with the U.S., has shifted from being a net importer of ATP goods to a net exporter. While U.S. ATP exports to China grew by 483 percent between 1990 and 2001 ($1.24 billion to $7.24 billion), Chinese ATP exports to the United States increased 8,126 percent (from $0.16 billion to $13.36 billion) and accounted for 6.8 percent of all U.S. ATP imports. China's shift in trade composition has widened the U.S. trade deficit for ATP goods with China from $1 billion in 1995 to $6.95 billion in 2000, (easing to $6.12 billion in last year's U.S. recession and technology slump but soaring by 40 percent for the first quarter of 2002). The United States now runs a deficit with China in almost two-thirds of the 650 individual ATP product lines tracked by the Commerce Department.[21]

In 2001, bilateral technology trade was primarily (more than 99 percent) in four product areas: Mechanical Equipment including Computers (46 percent); Electrical Machinery (35 percent); Aircraft and Spacecraft (12 percent); and Optical-Photographic and Measuring Equipment (almost 7 percent). Among these product areas, between 1997 and 2001, the U.S. deficit with China increased by $5.4 billion for the first two categories, while the U.S. trade surplus in the later two categories increased by less than $500 million.[22]

China is increasing capital investment in manufacturing capacity for advanced telecommunications and information technology products (such as silicon wafers) that are likely aimed at export to the United States.[23] The trends in the computer and peripheral equipment industries suggest U.S. reliance on Chinese manufactured components in such products is increasing. As noted by one financial analyst report, "China consumes 6 percent of global integrated circuit demand but only produces 1 percent itself; having moved operations to China, multinational corporations are demanding suppliers join them. China's integrated circuit sector is just emerging."[24] The trend in the telecommunication industry also suggests the manufacture of Chinese components is increasingly important.

Potential U.S. Dependency on Chinese Advanced Technology Imports - A key issue, along with the U.S. deficits in this trade area, is whether the United States is developing a dependency on Chinese imports that might undermine the U.S. defense industrial base. According to Commission research, China's capture of much of the U.S. manufacturing capacity in the high technology area could have serious implications for the United States. To the extent that U.S. surge capacity becomes increasingly dependent on component imports from China, the U.S. defense industrial base is correspondingly put at risk. The Commission intends to aggressively examine this issue and the potential impact on downstream and related industries.

According to a report on China's WTO agreement contracted by the Commission, the inability of import-sensitive

sectors to compete with Chinese imports can raise import dependency issues and, by implication, national security concerns. China has shown an extraordinary ability to rapidly expand production and exports in a wide range of products. It is unclear how much of this success flows from government subsidies and closed domestic markets. To date, the United States has paid little attention to dependency on imported products from any one nation, including China.[25]

The Commission has found that U.S. government data are currently inadequate to track properly industrial-technological-military dependencies. The Harmonized Standard codes, used by the U.S. Customs Service, and the Military Critical Technologies List, are impossible to cross-reference due to the insufficient specificity of both lists. Without the ability to cross-reference these lists, analyses of U.S. technological and military dependencies on imports from China are deficient. With globalization, sub-contractors are outsourcing key components. In 1992, the U.S. Navy and the Commerce Department traced the sourcing on three major projects and found 115 distinct items where a foreign dependency existed.[26] Shifts in the U.S. and world technology trade since 1992 have almost certainly increased that number.

U.S.-China Investment and Technology Transfer

An important factor behind the Chinese leadership's decision to embrace WTO membership was its continuing need to attract foreign investment, especially in high-technology sectors, from the U.S. and elsewhere. Foreign direct investment (FDI) has been a critical component of China's effort to develop its economy and advance its science and technology base. FDI both fuels China's economic growth and enhances aspects of its military development.

Over the past decade China has become the largest recipient of FDI in the developing world and one of the world's principal destinations for FDI. Between 1996 and 2000, almost 75 percent of China's capital inflows ($290 billion) were in the form of FDI ($217 billion). Unlike other developing countries, China has not heavily relied on foreign loans to finance its economic modernization; in fact, new foreign borrowing declined from a peak of $12.7 billion in 1996 to $10 billion in 2000.[28] The model of export-led growth and import substitution policies, conducted in tandem with increasing amounts of foreign direct investment and a tightly controlled currency, underpinned a decade of rapid economic growth.

The U.S. has been a key investor in the Chinese economy over the last ten years, with U.S. data indicating the direct investment position growing from $354 million in 1990 to $9.58 billion in 2000. Including Hong Kong, the gateway by which many U.S. firms gain access to the mainland, China became the preferred location of U.S. FDI not only in Asia but also among other developing nations. Only Mexico (as a result of NAFTA) and Brazil attracted more U.S. investment among the developing nations than China/Hong Kong over the second half of the 1990's, and in 2000 China overtook Mexico as the U.S.'s largest investment target.[29] Increasingly, U.S. firms have sought not only market access with their investments, but also low-cost manufacturing platforms to better compete in the global market.[30] According to Morgan Stanley, "China's massive consumer and labor markets do set it apart from the rest of the world, and for many U.S. firms, there is simply no choice but to be on the ground there."[31]

Figure 2.5

U.S. FDI Position in China by Sector

Sector	Invest Position in 2000 ($b)	% of Total Position in 2000	% Increase 1994-2000
Petroleum	1.846	19.3%	106%
Food Manufacturing	.181	1.8%	38%
Chemical	.245	2.6%	11%

Manufacturing			
Metals Manufacturing	.183	1.9%	76%
Machinery Manufacturing	.931	9.7%	N/a
Elec Equip Manufacturing	3.208	33.5%	1787%
Transport Equip Manuf.	.147	1.5%	N/a
Other Manufacturing	.768	8%	252%
Wholesale Trade	.362	3.8%	168%
Bank/Finance/Services	1.113	11.6%	179%
Other	.594	6.2%	357%
TOTAL	9.577	100%	275%

Source: United States Bureau of Economic Analysis data compiled by USCC staff

Over 400 of the world's 500 largest companies are now invested in China, with U.S.-based firms having been the largest investors for three consecutive years. U.S. direct investment outflow to China and Hong Kong in 2000 hit a record high of $4.4 billion - a 4 percent increase over 1999 and 3.1 percent of total U.S. direct investment abroad. American corporations' investments have been concentrated in higher value added manufacturing (electronics equipment, telecommunications equipment, transportation parts and equipment, etc.), services (insurance, financial and distribution), and petroleum, rather than labor-intensive manufactures (footwear, apparel, textiles, plastics).

Technology Transfer — With the objectives of modernization and self-sufficiency of the country's industrial and military sectors, China's leadership has methodically guided a remarkable drive for technological modernization.[32] China's leaders, including President Jiang Zemin, repeatedly emphasize the importance of developing independent, proprietary high-technology capabilities as a means to boost China's economic and military prowess to counter "hegemonic" actions of the United States.[33]

In an effort to develop indigenous high-tech industries, China's foreign import and investment policies have increasingly emphasized industry-specific investment and high technology imports.[34] China maintains a carefully integrated set of evolving industrial policies to "encourage, permit, restrict or ban" foreign involvement in very specific areas of technology and production. These guidelines were designed to encourage foreign investors to move away from labor-intensive projects towards joint-ventures in advanced technology, modern infrastructure development and high value-added goods. Beijing is also encouraging investment in the Western part of the country--raising concerns regarding joint partnerships with the many defense-related firms located in those inland regions.

In April 2002, the Chinese government issued its latest investment policy document, titled "Catalogue for Guiding Foreign Investment in Industry." The list of encouraged sectors grew by nearly 70 categories, while the list of restricted sectors grew by six categories. Most of the additional encouraged sectors were in manufacturing of advanced biotechnology, materials, electronics, communications equipment, and machine tools and manufacturing systems. Clearly, the identification of these sectors reflects the Chinese government's intent to direct foreign investment, management, and production technologies toward advanced manufacturing sectors.

Prior to agreeing with its WTO obligations to cease such practices, China's laws, regulations and policies with regard to foreign investment and trade included numerous provisions and mandates for foreign technology transfer. Technology transfers have also been used as a deal maker by U.S. firms seeking joint-venture contracts. The most significant offset initiative put forward by U.S. high-tech companies in seeking approval for joint-venture manufacturing partnerships or facilities in China is the establishment of an institution, center, or lab devoted to

joint research and development (R&D).[35]

In 2001, China's Academy of Sciences identified 124 high-tech R&D centers in China that had been set up by foreign firms. A large number of global technology firms have at least one R&D center working jointly with Chinese state controlled firms and universities, signifying a shift for multinational companies that had previously withheld their R&D work from China.[36] As China increasingly becomes a center for R&D, more technology transfer will occur and thereby threaten the U.S. domestic R&D base.[37]

The rate of U.S. investment in R&D in China by U.S. majority-owned foreign affiliates has increased significantly over the past two years. In 1997, U.S. firms invested $35 million in China and $14.5 billion worldwide for R&D. In 1999, investment jumped to $305 million in China (a 771 percent increase) - $292 million invested by manufacturing firms, and $26 million of that by chemical firms- and $18.3 billion worldwide (a 25 percent increase) for R&D.[38]

The scope and the nature of research done in China are advancing very rapidly.[39] As Alcatel's executive vice-president Ron Spithill recently told the *Financial Times*, "Very soon (China) will be a source of innovative technology."[40]

According to the Department of Commerce commissioned report *U.S. Commercial Technology Transfers to the People's Republic of China*, Chinese officials "frequently play foreign competitors against one another in their bids for joint-venture contracts and large-scale, government funded infrastructure projects in China. The typical result is usually more technology being transferred as competitors bid up the level or type of technology that they are willing to offer."[41] The report also stated: "...it is clear that foreign firms are being coerced into transferring technology (which they probably would not otherwise do) as the price to be paid for access to China's market."[42]

Under WTO, China has agreed not to condition investment or import approvals on technology transfer or requirements to conduct R&D in China. USTR officials informed the Commission that this commitment would apply to pre- as well as post-accession contracts.[43] Concerns exist that the government may impose more obligations, perhaps unofficially, to continue such requirements in exchange for favorable, extra-legal decisions by government officials at both the national and regional level.[44] This is an area that will be extremely difficult to police, as many companies wishing to do business in China make undisclosed concessions to beat out their competitors.

The American Chamber of Commerce in China (AmCham-China) explicitly expressed its skepticism in its annual white paper in 2001: "Despite the updating of provisional regulations on technology licensing in preparation for China's WTO entry, foreign companies are still required to submit technology licensing documents to the Chinese government for review — and licensors often must trade significant technology rights for approval to continue their project. In some industries, informal administrative measures in the form of 'advice' to foreign companies make technology transfer a pre-condition to market entry. AmCham-China strongly believes China needs to take a more progressive and open approach to end such irregular practices."[45]

The significance of these arrangements is profound. In a recent report to Congress on U.S.-China Science and Technology Cooperation, the State Department concluded: "This Chinese investment strategy, designed to extract technology transfer from American firms as a condition for entering the Chinese market, is, in State's estimation, the principal source of technology transfer from the U.S. to China."[46] State goes on to say that China "reaps a technology bonanza" from these investment policies. And, this trend will most likely continue, if not accelerate. The Chinese Academy of Sciences recently detailed a study that found that in 1997 only 13 percent of foreign firms in China applied the parent company's most advanced technologies in China. By 2001 that proportion had already risen to 41 percent and the Academy expects it will exceed 50 percent in 2002.[47]

Foreign Nationals Studying in the United States - The Commission finds that another principal means China is using to channel scientific and technological information to China is through Chinese foreign nationals studying and working in the U.S.

The recent State Department-coordinated report *U.S.-China Science and Technology Cooperation* concludes:[48]

- *it is clear that a major facilitating channel for the flow of scientific/technological information and know-how from the U. S. is the vast number of Chinese students annually present throughout the U.S. higher education system;*
- *it is State's belief that the large numbers of Chinese students, scholars, researchers and high-tech workers, ubiquitously present throughout the U.S. academic and industrial research establishment, collectively represent China's chief means of gathering information on U.S. scientific and technological development;*
- *viewed against the context of what China can glean from the proliferation of its nationals working in U.S. laboratories, whatever knowledge China might possibly have gained from cooperative S&T activities conducted under the 1979 S&T agreement would be negligible by comparison.*

Of particular importance is the fact that the large majority of these Chinese students are engaged in courses of study or research in fields related to mathematics, science and technology.[49] In 1999, 8 percent of the doctorates awarded in the United States in the sciences and engineering went to Chinese foreign nationals while U.S. citizens accounted for 22 percent of the doctorates.[50] The Commission emphasizes the State Department finding that "U.S. academic research laboratories throughout the country are hosts to thousands of Chinese students and researchers who have first-hand knowledge and participation in some of the most advanced S&T research projects across a spectrum of scientific disciplines. Many of these students return to China, taking their knowledge and expertise obtained in U.S. labs with them. Many others remain in the U.S., working in U.S. high-tech industry or remaining in academia."[51] U.S. high-tech firms, where the latest technologies are being developed, apparently also employ "thousands" of Chinese who have completed their studies in the United States, largely because they are unable to find sufficient numbers of S&T trained Americans. [52]

The U.S. Embassy in Beijing reports that it issued over 9,000 H1-B visas to Chinese in FY2001 for working in these high-tech firms.[53]

As with all foreign students studying in the United States, the U.S. Government has very limited knowledge as to their numbers, backgrounds, and activities here. In many cases, the U.S. Government loses track of them.

According to the Institute of International Education's "Open Doors On the Web," there were 59,939 Chinese students in the United States in the 2000/2001 academic year, a 10 percent increase over the previous academic year. Constituting the largest percentage of foreign students studying in the U.S., Chinese students accounted for 10.9 percent of all foreign students.[54]

The Commission recognizes that the U.S. high-tech community depends on the talent of foreign nationals, and similarly, that the size and configuration of the U.S. college and university system assumes that there will be large numbers of foreign students. Furthermore, the Commission values and recognizes the importance of exposing foreign nationals directly to our democracy and freedoms. However, the Commission believes that the lack of oversight of Chinese foreign nationals, as well as those of many other countries, studying and working in sensitive disciplines can have serious national security implications. The transfer of "know how" could potentially be applied to China's military industrial base. Consequently, the Commission concludes that increased oversight, review, screening and tracking of Chinese foreign nationals studying and working in the U.S. is necessary, and we support the recently signed into law "Enhanced Border Security and Visa Reform Act of 2002". The Commission stresses the importance of implementing and enforcing the law's provisions that seek to improve efforts to track foreign students in the U.S. to ensure that they maintain their appropriate visa status.

Impact on U.S. Jobs and Wages

There has been considerable debate over the impact that the U.S.-China economic relationship has on wages and employment levels in the United States. Evaluating the economic relationship with China is not only a matter of understanding the merits and drawbacks of free trade and globalization, but also involves questions of fair competition and American values. There are serious implications in exposing U.S. workers to competition with China - a non-market economy that is a conspicuous abuser of human, political, and labor rights and the environment.

A key question that the Commission's contracted research and public hearings have repeatedly raised is whether U.S. trade and investment with China are adversely impacting are not only wages and jobs in traditional manufacturing areas, but those in high-technology industries as well. Paul Craig Roberts, an economist and columnist, who served as an Assistant Secretary of Treasury in the Reagan Administration, recently wrote: "The upshot is that both American and Chinese firms produce for the U.S. and Chinese markets with Chinese labor. U.S. labor is not in the picture."[55]

While numerous arguments have been presented to the Commission that the U.S. economy benefits tremendously from its trade with China, we have also heard from labor representatives about the dislocation and virtual stagnation or decreasing standard of living that many U.S. workers face. The impact of trade with China on U.S. security interests — both military and economic — is complex. There are positive and negative aspects to the relationship which all parties must recognize in order to allow reasoned analysis and debate. In the opinion of the Commission, however, simply to accept a "business as usual" approach is not acceptable.

Through the course of three hearings on the impact of the U.S.-China trade and investment relationship on key American industries, the Commission heard a variety of opinions on the contentious topic of globalization. The Commission heard from academics such as William Overholt, a Senior Fellow at Harvard University Asia Center, about the benefits of the U.S.-China trade relationship:

> *They [China] get foreign investment in the things that they are good at, which are labor-intensive things; 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; 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.*[56]

The Commission heard of a different side of the relationship from labor representatives such as Richard L. Trumka, Secretary-Treasurer of the AFL-CIO:

> *When consumer demand is met with imports instead of domestic production, existing jobs can be lost, and new manufacturing jobs are not created in the U.S. Just since July of 2000 we have lost 675,000 manufacturing jobs in this country. In fact, the '90's boom is the only recovery in modern history during which we actually lost manufacturing jobs. This latest loss means that we now have fewer manufacturing workers in the United States than we did in 1965. U.S. workers who lose manufacturing jobs due to import competition take a pay cut of over 9 percent on average — when they are lucky enough to find a new job.*[57]

While the overall American economy experienced great growth and prosperity in the 1990s, not all workers or sectors of our economy benefited equally. The Commerce Department has argued that each $1 billion in exports creates 11,000 to 20,000 jobs. The Economic Policy Institute has stated that each $1 billion in imports may also cost 11,000 to 20,000 jobs. Hundreds of major U.S. brand name companies now manufacture in China and are no longer part of American communities producing jobs for American workers. The Commission heard from William Wolman, Chief Economist of Business Week: "Because U.S. imports have been growing faster than U.S. exports, it is likely that the international position of American workers is not improving but deteriorating. That is a major reason why there is no end in sight to wage stagnation in the United States and in other industrial countries."[58]

The Commission has heard that this trend of wage stagnation is not exclusive to blue-collar jobs but seems set to move into white-collar jobs as well.[59] While the Commission notes the low level of unemployment the U.S. has enjoyed, we are troubled that many Americans have not only been left out of wage increases but have in fact suffered wage decreases.

Implications of Competition with Chinese Workers - Many of the labor representatives that testified before the Commission detailed the implications of American workers competing with Chinese workers in a "race to the bottom". Pointing at the unfair competition implicit in Americans competing against Chinese workers who have been denied fundamental human rights such as the right to organize and collectively bargain, labor representatives such as Leo W. Gerard, International President of the United Steelworkers of America (USWA), have explained:

> *The right to strike, which is a fundamental right... was removed in China in 1982. There is no vehicle for workers to improve their standard of living. There is no vehicle for workers to dissent. There is no vehicle for workers to have an open opportunity to share in the wealth that they may create. So I don't know how we can expect ourselves to compete, and I don't know that we should expect ourselves to compete with that kind of a system... Everything that is going on in China in its industries is diametrically opposed to the values that this country holds so dear.*[60]

Lack of Adequate Data — Due to the inadequate statistics currently available, an accurate understanding of the wage and employment effects of the U.S. trade and investment relationship with China is difficult. In particular, while there are numerous statistics detailing how globalization is holding down inflation and increasing the profitability of U.S. corporations, there is a dearth of information regarding precisely how globalization is effecting American workers in the manufacturing and low-wage service sectors.

In part, the statistical inadequacies result from political bias. For example, during the Congressional debate on Permanent Normal Trade Relations with China, the Clinton Administration chose to release data on export sales state-by-state. In part, they extrapolated what the job gains would be for each state based on the rough estimate by the Commerce Department that each $1 billion in exports creates 11,000-20,000 jobs. At the same time, the Administration did not release import statistics on a state-by-state basis that would provide a clearer picture of the impact of the increased trade on job losses. Another example is the decision by the Department of Labor to stop releasing trade adjustment data sorted by zip code for fear that opponents of Administration policy initiatives would use the data to highlight the "cost" of Administration trade policies.

In an effort to overcome these statistical inadequacies, the U.S. Trade Deficit Review Commission contracted with Professor Kate Bronfenbrenner at Cornell University's School of Industrial and Labor Relations to complete a study that provided empirical findings through the use of a media-tracking system. The study tracked all media-reported production shifts out of the U.S. to China, Mexico, and other Asian and Latin American countries and out of Asian and Latin American countries into China that occurred between October 1, 2000 and April 30, 2001. The information was combined with macroeconomic data on imports, exports and investment. The study is the first and only national database on production shifts out of the U.S.[61]

Professor Bronfenbrenner detailed the study's key findings in her testimony before the Commission:

> *As increasing numbers of workers are displaced from manufacturing and export-related jobs into the service sector and import-related jobs; for many of them it has been a dramatic shift from permanent, unionized, full-time employment with good wages, health benefits, pension benefits, and regular hours to less secure, non-union jobs in the service sector and import-related industries, with lower wages, limited benefits, irregular part-time jobs, and less chance of union representation...In addition, increased publicity about global capital mobility has contributed to the effectiveness of employer threats of full or partial plant closure when bargaining with individual workers and unions over work rules, wages or benefits, or when campaigning against union-organizing initiatives.*[62]

Other significant highlights of the research were:

- *An increasing percentage of the jobs leaving the U.S. are in higher-paying industries ... It is these higher-end jobs that are most likely to be unionized and therefore more likely to have a much larger wage and benefit package. Many of those who lost their jobs were high seniority, top-of-the-pay scale employees, who have a great deal invested in their jobs and in their communities...*

- *There is a direct linkage between increases in trade deficits and foreign direct investment in certain industries and production and employment shifts out of the U.S. and into China in those industries.*[63]

The Commission believes that the U.S. Government needs to establish a federally mandated corporate reporting system that requires companies to report the presence and shift of production both from within the United States to overseas and from one overseas location to another. A thorough understanding of the impact trade and investment policies have on employment, workers, wages and communities, requires more information on such matters to allow policymakers to make informed decisions.

U.S. Supported Funding of Overcapacity - The Commission is also concerned about the impact on American workers of the U.S. Export-Import Bank and international financial institutions' (IFI) assistance to China. China accounts for approximately $6 billion of Ex-Im Bank's exposure, the largest of any country. China also has the largest portfolio in the World Bank, standing at $34.8 billion in commitments.

The most notable case of U.S.-support for funding global overcapacity has been Ex-Im Bank's guaranteeing of an $18 million medium-term loan to support the $21.7 million export of equipment and services by General Electric and other U.S. suppliers to the Benxi Iron & Steel Co. in Benxi, Liaoning, China. The Commission heard from representatives of the steel industry about the effect of Ex-Im Bank's guarantee to Benxi as well as their concerns about the implications for further action. As Leo W. Gerard, International President of the United Steelworkers of America testified:

> *It is irrational to have in excess of 20 steel companies in America either in bankruptcy, struggling to get out of bankruptcy with a half-a-dozen others on their way to bankruptcy, to have American taxpayer dollars through various funding agencies, whether it is the Export-Import Bank or others, funding that global overcapacity and to fund it in a non-market economy.*[64]

The issue becomes more complex when one considers that the guarantee to Benxi Iron & Steel directly supported 300 union jobs at GE's 1,600-employee Salem, VA plant, and represented 10 percent of the plant's production.[65] Regardless, Ex-Im Bank agreed to reassess its economic impact procedures. In addition, the recently passed Export-Import Bank reauthorization bill prohibits the Bank from providing financing that would be used by foreign entities to produce a product that is the subject of an antidumping or countervailing duty order. Entities that are the subject of a preliminary determination will be required to undergo an economic impact assessment before receiving Ex-Im financing.

While the effectiveness of the new procedures remains to be seen, there appears to have been little spillover on this topic to the examining of U.S.-supported international financial institutions (IFIs). The International Finance Corporation (IFC), for example, the arm of the World Bank Group that invests in the private sector, has invested in two different steel projects that are joint-ventures between Chinese and European companies: Scana Leshan Metallurgical Joint-venture Co., Ltd. and Shanghai Krupp Stainless Co., Ltd. Each project contributes to increasing global overcapacity in steel products. While these two projects may result in developing portions of China's economy, there has been no economic impact assessment on the U.S. steel industry. China is currently the IFC's ninth-largest country portfolio and is one of its fastest growing client countries. Without proper oversight in the form of an economic impact assessment on the U.S., U.S. taxpayers may have invested in an IFI that is harming the U.S. economy and U.S. workers.

Witnesses have expressed concern to the Commission that with over 105 million Chinese living on less than $1.00 a day and with little or no access to clean water, productive farmland, sufficient education, or adequate health services, U.S. taxpayer funding that was targeted towards poverty reduction is being diverted to increasing the international competitiveness of China's steel industry. Witnesses have found this particularly troubling in light of China's massive currency reserves that would be more appropriately used for improving their own steel industry.

U.S. participation in International Financial Institutions should reflect U.S. policy; in particular, U.S. delegates to the IFIs should not counter actions taken by the U.S. Government to stem the global oversupply of steel. Other important policy objectives must also be reflected in U.S. efforts at the IFIs.

National Security Implications

The U.S.-PRC trade and investment relationship over the past decade has had serious implications for U.S. national security. U.S. policies have played an important role in helping the Chinese leadership achieve stunning economic growth and the modernization of their military industrial complex.

The large and growing U.S. trade deficits with China pose economic and security concerns for the U.S. Many observers, including Federal Reserve Board Chairman Alan Greenspan and former Treasury Secretary Robert Rubin have stated that the U.S. trade deficit is unsustainable. In 2001, the contribution of the U.S.-China trade deficit to the overall U.S. trade deficit constituted about one-fifth of the $393 billion total. As U.S. imports far

outpace exports, the U.S. must finance this imbalance.

The U.S.-PRC trade relationship plays an important role in China's ability to maintain global trade surpluses and accumulate large foreign reserves. If China's $83 billion surplus with the United States were removed, China would have had a 2001 trade deficit of $60 billion with the rest of the world. Large trade surpluses and large net financial inflows have allowed China to build up foreign reserves that stood at $212.2 billion at the end of 2001- a one-year increase of $46.6 billion. These reserves are in addition to China's 500 tons of gold reserves. China's foreign reserves are now second only to Japan's, assuring increasingly significant financial and strategic options.[67] They are particularly important to China's military modernization, as Beijing continues to rely on hard currency to purchase advanced weapon systems abroad. The Commission is concerned with the military implications of China's foreign reserves and discusses them in more detail in Chapter 9.

The Chinese leadership guided their trade and investment strategies with the objective of leapfrogging in developing their science and technology base. U.S. firms, to obtain a foothold in the Chinese consumer market, played a significant role in this development. With U.S. help, China has developed into a major global manufacturing center and a rising global R&D center, raising serious questions as to U.S. dependency on China for key items of our defense industrial base.

Over the past decade U.S. trade and investment policy with China has too often favored short-term commercial and corporate interests over broader national economic and military security concerns. As we move forward in the relationship, the United States needs to strike a more appropriate balance. The U.S. government should provide more oversight of U.S. firms' R&D investment and commercial technology transfers. As well, more oversight and tracking is needed to evaluate the hollowing-out of the U.S. industrial base and to determine whether import dependencies may be developing that can undermine our defense industrial base and thereby threaten national security.

The Commission will continue to monitor and report regularly on the composition of trade and investment, shifting patterns and trends and dependencies, commercial technology transfers and R&D collaboration, and the challenges to U.S. exporters and workers.

Recommendations

- The Commission recommends the Congress request the U.S. Government review the statistical discrepancy between the National Institute of Science and Technology (NIST) and the Census Bureau trade figures that are based on different methodologies and definitions, in order to remove the complications and discrepancies that have plagued analysis of U.S. China trade and investment analysis.

- The Commission recommends the Congress request the Commerce and Defense Departments to increase the level of detail of the Harmonized Standard (HS) code and Military Critical Technologies List (MCTL) so they may be cross-referenced to track any developing U.S. dependency on China. To further enhance the U.S. Government's ability to track dependencies, Congress should also direct the Department of Defense to require its contractors and subcontractors to identify components and sourcing using the HS codes.

- The Commission recommends the Congress support efforts of various government agencies to increase contracts and exports of U.S. goods to China but should monitor and evaluate these efforts to ensure that they are enhancing U.S. job creation and are not increasing capacity in industries that already have excess world capacity.

- The Commission recommends the Congress establish and fund a federally mandated corporate reporting system to gather sufficient data to provide a comprehensive understanding of the trade and investment relationship with China. Within such a system, companies should be required to report their initial investments in China; any technology transfer, offset, or R&D cooperation agreed to as part of the investment; the shift of production capacity and job relocations resulting from the investment, both from within the United States to overseas and from one overseas location to another; and contracting relationships with Chinese firms. In addition, Congress should require the Commerce Department to maintain an authoritative account of U.S. firms' investment in R&D centers in China and a comprehensive

assessment of their activities.

- The Commission recommends the Congress request the Treasury Department to conduct employment impact studies of International Financial Institutions' (IFI) projects. U.S. representatives to the IFIs should be instructed to use their voice and vote to support programs that promote U.S. interests and do not negatively effect U.S. employment or fund industries, such as steel, with global over-capacity.

- The Commission recommends the Congress should closely monitor the implementation of the "Enhanced Border Security and Visa Reform Act of 2002". The U.S. government has a poor record of implementing any effective mechanism to track and assess the activities of the very large number of Chinese students, scholars, and researchers present in the U.S. academic and industrial establishment. Careful implementation of the new legislation is required, if the U.S. is to address this serious matter.

ENDNOTES:

1. To put U.S., E.U., and Japan trade data on a comparable basis this chapter uses WTO trade data when available. 2001 WTO data have yet to be released. All other data comes from individual country sources. (According to U.S. Census Bureau data the U.S. trade deficit with China declined modestly from $83.8 billion in 2000 to $80.0 billion in 2001).
2. Gordon Chang, China's Capital Needs, Report prepared for the U.S.-China Security Review Commission, 8 May 2002, Section 3, 1.
3. For example, manufactures represented nearly 80 percent of U.S. exports to China and more than 95 percent of U.S. imports from China in 2000. The other categories of goods trade are agricultural and mining, for which the U.S. posted a surplus with China of less than $1 billion in 2000.
4. Richard MacGregor, "Beans Are on the Beijing Menu as Bush Prepares to Talk Trade," Financial Times, 21 February 2002, sec. A, 1.
5. Charles W. McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, Report prepared for the Commission, May 2002, 6.
6. U.S.-China Security Review Commission, Technical Briefing on Business, Trade and Economic Issues, Oral Testimony of Nicholas Lardy, 9 May 2001, 177.
7. U.S.-China Security Review Commission, U.S.-China Current Trade and Investment Policies and their Impact on the U.S. Economy, Oral Testimony of Kevin Kearns, 14 June 2001, 125.
8. Joseph P. Quinlan, "America's Trade Deficit with China: Why It's Here to Stay," Morgan Stanley Equity Research, Special Economic Study, 22 March 2002, 7.
9. "China '02 Direct Foreign Invest Seen up 7 percent to $50 billion," Dow Jones Wire, 2 April 2002.
10. Lardy, Oral Testimony, 180.
11. "U.S. Largest China Investor for Third Year," ChinaOnline.com, 14 February 2002, <http://www.chinaonline.com> (14 February 2002).
12. MacGregor, "Beans Are on the Beijing Menu as Bush Prepares to Talk Trade," sec. A, 1.
13. U.S.-China Security Review Commission, Bilateral Trade Policies and Issues between the U.S. and China Oral Testimony of David McCurdy, 2 August 2001, 359.
14. In September 1999, the International Trade Commission (ITC) issued a report that attempted to estimate the impact of China's entry into the WTO on the trade flows between the U.S. and China. The report, which based its assessment on the status of negotiations at that time, estimated that U.S. exports to China would increase by approximately 10 percent and U.S. imports from China would increase by approximately 7 percent. This would result in an increase in the U.S. trade deficit with China (due to the fact that the volume of imports far exceeded the volume of exports).
15. U.S.-China Security Review Commission, WTO Compliance and Sectoral Issues, Oral Testimony of William H. Lash, III, 18 January 2002, 55.
16. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on The Treasury Department's Report to Congress on International Economic and Exchange Rate Policy, Written Testimony of Ernest H. Preeg, 106th Congress, 2nd Session, 1 May 2002, 5.
17. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on The Treasury Department's Report to Congress on International Economic and Exchange Rate Policy, Oral Testimony of C. Fred Bergsten , 1 May 2002 (unofficial transcript reported by Federal News Service, Inc).
18. For one example of media coverage on China's role in the high tech sector and future ambitions, see Jim Erickson, "The Next Tech Superpower," Asiaweek.com, 27 July -3 August 2001.
19. Since 1989, the U.S. Department of Commerce has maintained a continually updated list of Advanced Technology Products (ATP). This ATP list is maintained at the 10-digit Harmonized Code level of specificity. In 2001, two-way ATP trade accounted for $395 billion -- 21percent of total U.S. trade with the world.
20. McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, 3-4.
21. Ibid., 3-5.
22. Ibid., 3-5.
23. United Nations Commission on Trade and Development, World Investment Report 2001, (Geneva; 2001), 26.
24. Credit Lyonnais Securities Asia Emerging Markets, "The Janus Face," (Hong Kong; January 2002), 31.
25. Terence Stewart, Accession of the People's Republic of China to the WTO, Report prepared for the Commission, April 2002, 128.
26. Pat Choate and Edward Miller, An Analysis: The U.S. Industrial Base and China, Report prepared for the Commission, June 2002, 14.
27. China Statistical Year Book 2001, Table 17-13, Compiled by USCC Staff.
28. Ibid.
29. Quinlan, "America's Trade Deficit with China: Why It's Here to Stay," 3.
30. Ibid., 5.
31. Ibid., 5.
32. U.S. Department of Commerce, U.S. Commercial Technology Transfers to the People's Republic of China, 1999, i.
33. "Jiang: Space Station in China's Future," China Online, 28 March 2002, reporting from the China News Service of 26 March 2002, as cited in McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, 11.
34. U.S. Department of Commerce, U.S. Commercial Technology Transfers to the People's Republic of China, iii.
35. Ibid.
36. McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, 14.
37. Ibid.
38. Bureau of Economic Analysis statistics, U.S. Department of Commerce. These R&D figures are only available for U.S. majority owned foreign affiliates of U.S. parent firms. Compiled by USCC Staff.
39. McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, 14.
40. James Kynge, "Rich vein of raw talent makes China potential R&D hothouse," Financial Times, 19 April 2002.
41. U.S. Department of Commerce, U.S. Commercial Technology Transfers to the People's Republic of China, iv.

42. Ibid., 96.
43. Letter from Peter Davidson, General Counsel, USTR, to the Commission, dated October 16, 2001 and U.S.-China Security Review Commission, Hearing on WTO Compliance and Sectoral Issues, Oral Testimony of Jeffrey Bader, 18 January 2002, 96.
44. United States Trade Representative, Foreign Trade Barriers 2001, April 2002, 68.
45. American Chamber of Commerce – China, American Business in China: 2001 White Paper, February 2001, 60.
46. U.S. State Department, Report on U.S.-China Science and Technology Cooperation, May 2002, 63.
47. McMillion, China's Very Rapid Economic, Industrial and Technical Emergence, 13.
48. U.S. State Department, Report on U.S.-China Science and Technology Cooperation, 61-62.
49. Ibid., 61
50. National Science Foundation, Science and Engineering Indicators -2002, <http://www.nsf.gov/sbe/srs/seind02/pdf_v2.htm> (24 June 2002).
51. U.S. State Department, Report on U.S.-China Science and Technology Cooperation, 61.
52. Ibid.
53. Ibid.
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55. Paul Craig Roberts, "When Shibboleths Crowd Out Thought," The Washington Times, 9 April 2002, sec. A, 16.
56. U.S.-China Security Review Commission, Hearing on WTO Compliance and Sectoral Issues, Oral Testimony of William Overholt, 18 Jan. 2002, 229.
57. U.S.-China Security Review Commission, Hearing on U.S.-China Current Trade and Investment Policies and Their Impact on the U.S Economy, Written Testimony of Richard L. Trumka, 14 June 2001, 3.
58. U.S.-China Security Review Commission, Hearing on U.S.-China Current Trade and Investment Policies and Their Impact on the U.S. Economy, Oral Testimony of William Wolman, 14 June 2001, 120.
59. U.S.-China Security Review Commission, Hearing on U.S.-China Current Trade and Investment Policies and Their Impact on the U.S. Economy, Oral Testimony of Anne Colamosca, 14 June 2001, 151.
60. U.S.-China Security Review Commission, Hearing on Bilateral Trade Policies and Issues Between the U.S. and China, Oral Testimony of Leo W. Gerard, 2 August 2001, 24.
61. The study can be found at www.ustdrc.gov.
62. U.S.-China Security Review Commission, Technical Briefing on Business, Trade, and Economic Issues, Oral Testimony of Kate Bronfenbrenner, 9 May 2001, 199-200.
63. Kate Bronfenbrenner, Impact of U.S.-China Trade Relations on Workers, Wages, and Employment: Pilot Study Report, Report prepared for the Commission, 30 June 2001.
64. Gerard, Oral Testimony, 22.
65. "EX-IM Bank Supports $22 Million Sale of U.S. Equipment to China," 2 January 2001 Press Release by Ex-Im Bank. <http://www.exim.gov/press/jan0201.html> (16 June 2002)
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Exhibit 4

REVISED VERSION
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Exchange Rate Manipulation to Gain an Unfair Competitive Advantage:
The Case Against Japan and China

by

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Article IV of the IMF Agreement states that members should "avoid manipulating exchange rates . . . in order . . . to gain an unfair competitive advantage over other members," and the related surveillance provision defines manipulation to include "protracted large-scale intervention in one direction in the exchange market." In other words, if a U.S. trading partner makes protracted large-scale purchases of dollars and other currencies (i.e., one direction intervention), which leads to a lower than market-based exchange rate and a larger than market-determined trade surplus, there is *prima facie* evidence of IMF proscribed exchange rate manipulation to gain an unfair competitive advantage.

In this context, this paper examines four questions:

1. Have Japan and China, among others, been manipulating their exchange rates in recent years, as defined by the IMF?

And if so:

2. What has been the impact of such currency manipulation on the dollar exchange rate and the U.S. trade deficit?

3. What are the consequences for U.S. economic and foreign policy interests?

4. How should the U.S. government respond?

1. Have Japan and China, Among Others, Been Manipulating Their Exchange Rates in Recent Years, as Defined by the IMF?

The answer begins with an assessment of the two adjectives about intervention, "large scale" and "protracted." In the cases of Japan and China, as shown in Tables 1 and 2, they unquestionably apply. Japanese one direction intervention to buy dollars and other foreign exchange totaled $233 billion since 1998, with large purchases each year, including $48 billion during the first seven months of 2002. Chinese cumulative purchases were $98 billion since 1998, with a sharp upward trend to $46 billion in 2001 and $31 billion, or more than $5 billion per month, during the first six months of 2002.

In the case of ***Japan***, official foreign exchange purchases equaled 59-61 percent of the trade surplus in 1999-2001 (Table 1, line B 1). For the broader basic balance measure of current account surplus plus FDI net flow (line B 4), the figures rise to 72-77 percent. What this means is that the protracted intervention has directly offset, dollar for dollar, about 60 percent of the upward pressure on the yen from the very large trade surplus, and about 75 percent of the net inflow of dollars from the basic balance surplus. Moreover, in addition to this direct quantitative relationship, Japanese currency intervention policy has a strong reinforcing qualitative dimension, which can be called the "credible threat multiplier effect." The experience has been that when faced with upward pressure on the yen, not only does the Bank of Japan buy large quantities of foreign exchange, but the Ministry of Finance states emphatically that Japan will intervene as much as necessary to keep the yen down, as an overriding economic policy objective to ensure continued export-led growth.[1] Such statements strongly dissuade currency dealers from intervening in anticipation of market-generated upward pressures on the yen. The overall result is currency manipulation through a combination of large-scale intervention plus credible threats of further intervention, with the latter constituting the "multiplier effect." A reasonable adjustment for this multiplier effect could raise the trade surplus offset from 60 percent to 75 percent and the basic balance offset from 75 percent to 100 percent.

Based on these relationships, how much stronger would the yen be if currency manipulation were halted through a categoric statement by the Government of Japan that it would indefinitely cease all purchases of foreign exchange. The rise in the yen would almost certainly be substantial, quite possibly by at least 20 percent, to 100 or less yen to the dollar. Such an assessment, moreover, is supported by another quantitative relationship related to the U.S. trade deficit. The U.S. trade deficit, as a share of total trade, is similar to that of the Japanese trade surplus, and considerable econometric work has produced the rule of thumb that a 1 percent decline in the dollar would reduce the U.S. trade deficit by $10 billion, and thus a 20 percent decline would reduce the trade deficit by $200 billion, or by half of the total U.S. trade deficit. This relationship can be compared with Japanese official intervention, to opposite effect, amounting to a 75 percent offset to upward pressures on the yen from the trade surplus, and thus to an implied strengthening of the yen from termination of the intervention of 30 percent. In other words, if a 20 percent decline in the dollar exchange rate can cause a 50 percent decline in the U.S. trade deficit, currency manipulation to offset 75 percent of the Japanese trade surplus impact on the exchange rate would equate to a 30 percent weaker yen. To err on the conservative side, however, ***the conclusion drawn here is that Japanese currency manipulation probably results in a yen exchange rate at least 20 percent lower than it would be based on market forces alone.***

In the case of ***China***, the renimbi is fixed to the dollar, but is nonconvertible on capital account. What this means in practice is that export earnings in foreign exchange, plus FDI not utilized for purchases on current account, have to be sold to the central bank for renimbi at the fixed exchange rate. In effect, official intervention is carried out through mandatory foreign exchange sales to the central bank rather than central bank purchases in the market, as take place in Japan and elsewhere. The net effect, nevertheless, is currency manipulation through protracted large-scale purchases of foreign exchange by the Chinese central bank.

As to how much stronger the renimbi would be if the central bank ceased to buy foreign exchange, the basic analytic approach would be the same as applied to Japan, although with more indirect assumptions as to what would take place if the renimbi were freely convertible, and the appraisal is thus limited to an order of magnitude. The ratios of official foreign exchange purchases to the trade surplus and basic balance net dollar inflows have been rising sharply in 2001 and 2002. During the first six months of 2002, central bank purchases have been at an annual rate of $62 billion, or roughly 200 percent of the trade surplus, and about 100 percent of the basic balance

[1] Such statements, incidentally, constitute official admission that the intent of the intervention is to gain a competitive advantage in trade.

inflow. These ratios, compared with Japan, indicate a rough order of magnitude for exchange rate impact almost double that caused by Japanese intervention. This should not be surprising because during 2002 the dollar linked renimbi has declined 10 percent vis-à-vis the yen and the euro, with consequent strong positive impact on the Chinese trade surplus (up 55 percent in the first half of 2002) and FDI inflow (up 22 percent during January-July). Moreover, even with the $62 billion annual rate of mandatory sales to the central bank, market pressures from the huge foreign exchange net inflow stimulate underground cash flows out of the country of billions of dollars per year, linked to massive official corruption.[2] Taking all of these factors into account, ***the conclusion drawn here is that Chinese currency manipulation probably results in a renimbi exchange rate in the order of 40 percent lower than it would be with a convertible rate based on market forces alone.***

The impact on the U.S. trade deficit.—The bottom line question is how much smaller the U.S. trade deficit would be if others did not manipulate their currencies as described above. In this case, the analysis is more straightforward. Assuming the renimbi 40 percent stronger vis-à-vis the dollar, and the yen, the Korean won, and the Taiwanese dollar (the latter two with intervention/trade surplus ratios similar to that of Japan) 20 percent stronger, the dollar exchange rate, weighted by U.S. imports, would be 7 percent lower. Based on the rule of thumb that a 1 percent decline in the dollar would lead to a $10 billion reduction in the trade deficit, the net result would be a $70 billion reduction in the U.S. trade deficit if these four trading partners ceased currency manipulation.

This calculation, however, understates the trade impact for several reasons. Exports of these four trading partners are almost entirely in manufactures, which have relatively high price elasticities[3] compared with other sectors of trade, and therefore this trade would have an above-average quantitative response to a given exchange rate adjustment. Moreover, their exports have grown rapidly in recent years and thus the $10 billion/1 percent benchmark, based on earlier econometric work, should be adjusted upward. There has also probably been some additional currency manipulation beyond the four cited here, particularly during 2002 when the effects of the recession in the United States and a declining dollar have weakened export performance around the world and created political pressures to intervene and keep currencies down relative to the falling dollar. For example, Russia, India, and Thailand have made substantial official purchases of foreign exchange during the first half of 2002 even while running large current account surpluses. Bringing all of these factors together, ***the conclusion drawn here is that roughly $100 billion, or about one-quarter of the total U.S. trade deficit, can be attributed to currency manipulation.***

3. What Are the Consequences for U.S. Economic and Foreign Policy Interests?

There are three distinct adverse consequences for U.S. interests from the currency manipulation that has resulted in a U.S. trade deficit roughly $100 billion larger than it would be based on market-determined exchange rates alone: (1) the short-term impact on jobs and output; (2) the longer term economic impact on U.S. productivity and growth; and (3) the broader effects on U.S. foreign policy interests. Only the first has received serious attention, while the second and third consequences are at least as important for overall U.S. interests, and possibly more so.

1. ***The short-term impact on jobs and output.*** The rising U.S. trade deficit means less jobs and output for both U.S. export and import-competing industries. The National Association of Manufacturers (NAM) estimates that since August 2000, 500,000 jobs have been lost from the decline in exports alone. Relating a $1 billion increase in the trade deficit to 15,000 jobs, a $100

[2] See the *Financial Times*, August 22, 2002, p. 5, "China gears up to halt capital flight." The article cites estimates of capital flight as high as $20 billion per year, as well as a temper tantrum by Chinese Premier Zhu Rongji over the fact that nearly every corruption scandal in China in the last decade involves around officials, or businessmen who have bribed them, fleeing overseas with large amounts of money.

[3] The price elasticity relates percentage changes in relative prices and quantities of goods traded. For example, a -2 elasticity of demand for imports means a 1 percent decline in the relative price of imports would lead to a 2 percent increase in the quantity of imports.

Exhibit 5

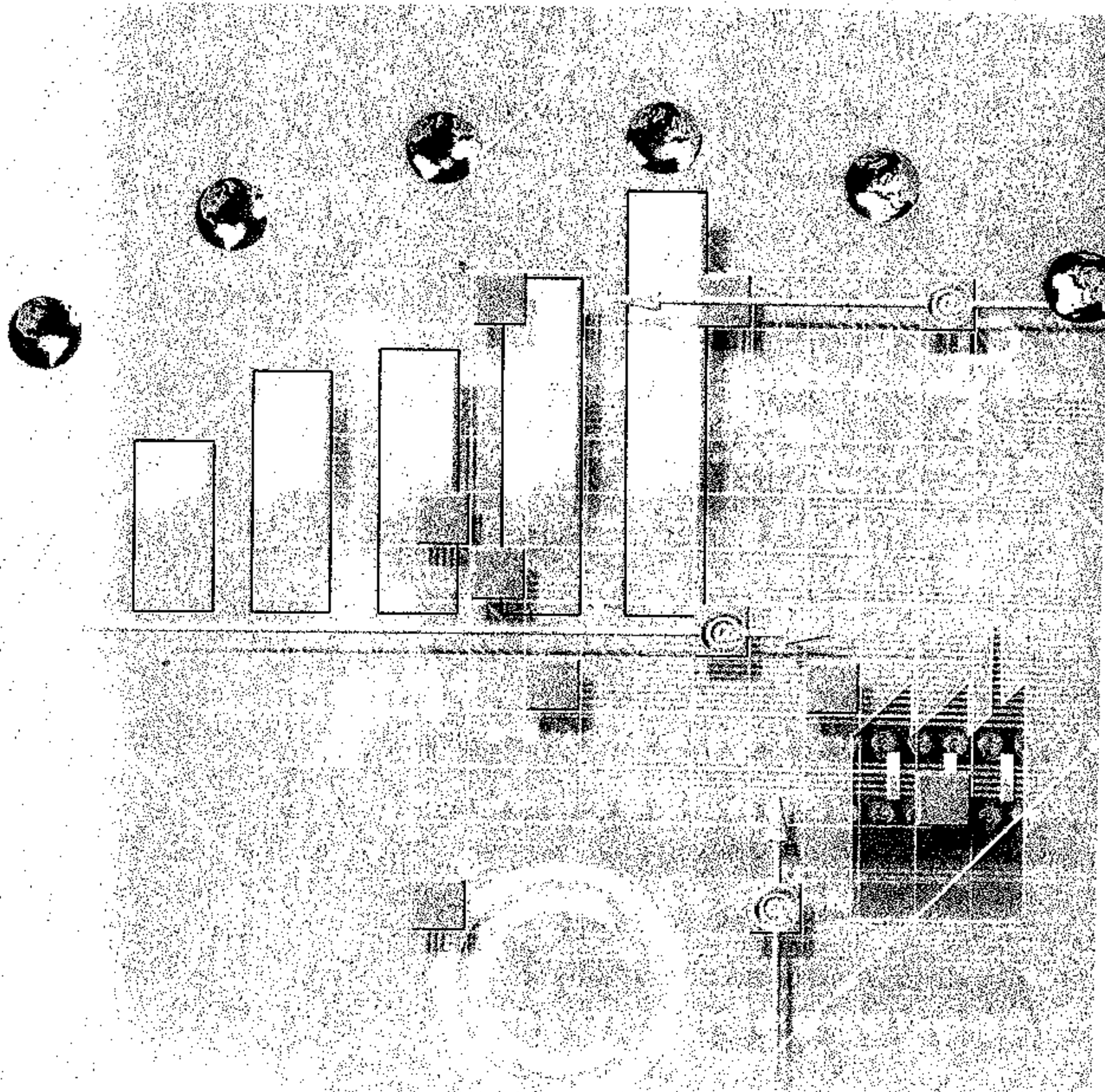
Economist Intelligence Unit

The Economist

Country Commerce

MAIN REPORT

China 2004



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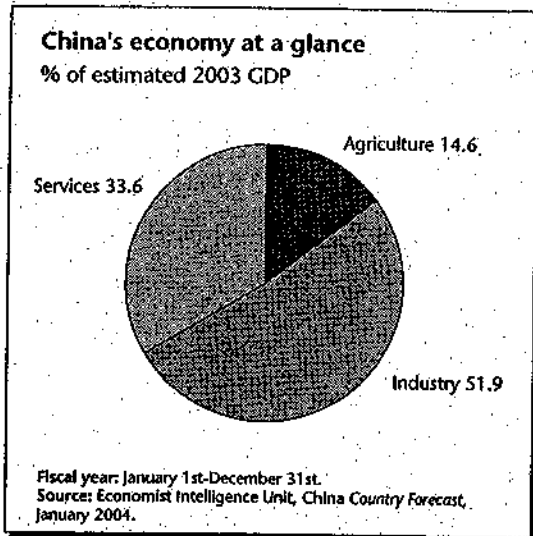

Fiscal year: January 1st-December 31st.
Source: Economist Intelligence Unit, China *Country Forecast*, January 2004.

erful new Ministry of Commerce (MOFCOM) was created. It incorporates nearly all the powers of the now-defunct Ministry of Foreign Trade and Economic Co-operation, and some policymaking and regulating bureaucracies previously under the State Economic and Trade Commission and the State Development and Reform Commission. MOFCOM was designed as a super-ministry in charge of both internal and external trade, reflecting China's admission in late 2001 to the World Trade Organisation and the gradual dismantling of barriers to domestic and foreign economic transactions.

Several other important agencies were also created in early 2003. They include the China Banking Regulatory Commission, which took over the watchdog functions from the central bank, and the State-owned Assets Supervision and Administration Commission, which will probably play a major role in the privatisation of state enterprises in the years ahead.

The new leaders are not expected to make any immediate dramatic changes in Chinese policies. They will probably stress continuity during their first years in charge, since they owe their jobs to the previous generation of leaders. Nevertheless, they will have to address the immense political and social pressures that challenge Chinese society. For example, shortly after assuming power, the new leaders faced a major crisis: the outbreak of Severe Acute Respiratory Syndrome (SARS). The outbreak forced them to bring about a more transparent attitude virtually overnight since they were confronted with widespread local and foreign concern about the real extent of the epidemic. Several high-profile corruption cases over the past few years have also demonstrated that problems with graft and political disillusionment extend to the top levels of the political system.

These problems point to the fundamental weakness in China's political system. After more than five decades of authoritarian rule, there are few channels for ordinary individuals to protest official graft, and no movement or group of persons can serve as a credible alternative to the Communist Party. Because the leadership has eschewed political reforms as they liberalise the economy, it has allowed few channels for divergent political views. Political dissidents are routinely given long prison sentences.

China's leaders will probably face more social instability and public dissatisfaction in the years ahead. Their stated goal of paying more attention to those left behind during the quarter century of reform is a sign that they wish to address economic and social problems.

In foreign politics as well, the new leaders around Mr Hu stress the need for continuity, of particular importance in China's roller-coaster relationship with the United States. Despite a rocky start after George W Bush assumed the presidency in January 2001, ties with the US improved steadily throughout 2003, culminating in Mr Wen's visit to the US and red-carpet welcome in Washington in December 2003. Sino-US relations have improved because of the two countries' common interest in fighting terrorism. However, China has expressed concern over US activist foreign policies, reflected most spectacularly in the US-led attack on Iraq in early 2003 and also in its stationing of troops in areas close to Chinese borders.

Ties with Taiwan, which China considers a renegade province, remained uneasy in early 2004, mainly because of China's intense suspicion of Taiwan's president, Chen Shui-bian, a former advocate of independence from the mainland. Mr Chen has led the island since May 2000 and seeks re-election in a presidential race set for March 20th 2004. China's suspicions were further strengthened in late 2003 when Mr Chen pushed ahead with plans for a referendum at the same time as the presidential election on whether the Taiwan authorities should demand that China abandon its military threats against the island.

Most of the laws forming China's modern legal system have been written from scratch since the beginning of economic reforms in the late 1970s. Although many observers have been impressed with the comprehensiveness and speed with which new laws have been issued, legislation still leaves much to be desired. Nevertheless, it is widely believed that China's accession to the World Trade Organisation in December 2001 has accelerated the promulgation of new laws, especially on foreign trade and investment.

Foreign companies are still hampered by a lack of transparency on details of new regulations. Important new rules often take the form of administrative notices, rather than laws passed by legislatures at various levels; moreover, they are initially

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Fundamental indicators: production and consumption

% growth

	2002 *actual*	2003 *estimate*	2004 *forecast*
GDP	8.0	8.6	8.4
Private consumption	6.6	6.0	6.8
Government consumption	7.0	9.0	5.0

Source: Economist Intelligence Unit, *China Country Forecast*, January 2004.

distributed internally along bureaucratic channels before being published, often in an incomplete fashion, in the state-run media.

Between this lack of transparency and a long history of lacklustre implementation, foreign companies cannot always feel assured of consistent and fair treatment by the bureaucracy. But the quality of the Chinese bureaucracy should improve in the coming years for two reasons: WTO membership will expose China to foreign practices, and the downsizing of the staff in government offices in recent years will probably leave in place mainly the more efficient workers.

Chinese law allows foreign companies to file suits in local courts, but many prefer arbitration because of concerns about the speed and impartiality of the courts. A related concern is the weak tradition of consistent implementation of court rulings, especially if they favour foreigners over locals. These shortcomings undermine confidence in the Chinese judicial system among both foreign entities and broad sections of Chinese society. The main cause is the absence of a clear-cut division of powers; thus, the courts act in close co-operation with politicians and officials. The spread of corruption in post-reform China has also affected the courts. Judicial staff in the largest cities (such as Beijing and Shanghai) improved considerably during the reform years, but graft remains a serious problem in many provinces.

China's business environment is set to improve—albeit gradually—as the communist government takes steps to accord greater public recognition to the role of private business. This was particularly emphasised during the Communist Party's 16th Congress, which amended the party's charter to allow private entrepreneurs to become members. That followed amendments to the state constitution in March 1999 that recognised the "important" role of the private sector. The Standing Committee of the NPC met in late December 2003 to discuss constitutional amendments that would give private property the same status as public property and guarantee that "private property obtained legally shall not be violated". The annual full meeting of the NPC in March 2004 will probably pass the amendments.

Nevertheless, the security of contracts remains problematic. Foreign investors often complain of the maze of regulatory difficulties they encounter in pressing their local partners to adhere to previously agreed understandings. China's entry into the WTO and foreign firms' increasing recourse to legal action might improve matters on this front.

For more information on political conditions, see the Economist Intelligence Unit's *Country Report* on China.

1.2 Market conditions. China's economic expansion accelerated to 9.1% in 2003, according to the National Bureau of Statistics. This was significantly higher than both the 7% target set early in the year and the 8% rate of 2002. The strong performance was the result of booming exports and continued heavy government spending (such as in infrastructure). Non-government investment spending also played a growing role. But local consumers continued to spend less than policymakers hoped. At a key economic planning meeting in Beijing in early December 2003, the authorities set a target of 7% economic growth for 2004.

Investment by state companies in fixed assets such as new plants and equipment increased by 26.7% in 2003, according to the National Bureau of Statistics. Although these investments help make China the world's fastest-growing major economy, they take a heavy toll on government finances. Ministry of Finance officials expect a deficit of Rmb319.8bn (about US$38.6bn) for 2003, up from Rmb309.8bn in 2002.

The government has been priming the economic pump since 1998 to lift growth, partly by issuing off-budget bonds, of which it sold Rmb140bn in 2003. Observers have warned that China probably has only four or five more years in which it can finance such heavy spending before the public deficit grows to dangerous levels. Economic growth might also slow if investment proves to be excessive in sectors such as car manufacturing, possibly creating excess supply down the road.

Despite the continued weak global economy, Chinese exports increased by 34.6% year-on-year, to US$438.4bn in 2003, a clear improvement from the 22.3% increase in 2002. Mean-

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dollar and other major currencies, based on the previous day's closing prices in the interbank market. Should the rate fluctuate during the day outside a narrow set band, the central bank maintains a special hard-currency account for intervention.

1.4 State role in the economy. China's state-owned enterprises (SOEs) are generally characterised by severe losses, inefficient allocation of resources and poor management. But there are significant exceptions: Huawei Technologies (which makes telecommunications equipment) rapidly expanded its exports, helped by a research staff that accounts for half its employees; TCL Holdings (which makes television sets and announced a spectacular merger with the television operations of French company Thomson in early November 2003) has aggressively branched out into new business opportunities in fields such as cellular phones.

The government is pushing ahead with reforms of its SOEs. The process began in earnest in 1998 but could take a decade or more to complete. Large SOEs are getting more autonomy and the right to sell shares to non-state investors. The government sometimes gives up its controlling stakes or even sells off companies altogether. (For examples of China's major state-owned enterprises, see the box on page 10).

The official line is that the 46,800 SOEs will remain the backbone of the economy, but the rapid growth of private domestic, foreign-owned and joint-venture companies are rapidly undermining them. This trend will probably become even more pronounced as China gradually opens its markets further under its World Trade Organisation commitments.

The increased emphasis on non-state companies gained a firmer legal basis with the adoption in March 1999 of constitutional amendments raising the status of the private sector (see below). Another indication of this shift was the decision of the ruling Communist Party to welcome private entrepreneurs to its ranks; this decision was enshrined in the amended charter adopted at the party's 16th Congress in November 2002.

Still, there are growing concerns about the speed of reform, especially since the SOEs need to become more efficient to stay competitive now that China is a member of the WTO. Equally worrying, the state still holds mandatory control over "vital" economic sectors, a principle that has been emphasised in the Tenth Five-Year Plan (2001–05). The SOEs include large concerns operating in finance, transport, telecommunications, energy, heavy industry and other essential areas of the economy.

SOEs in theory belong to the Chinese people, and their management remains under state supervision. But market pressures have begun changing the SOEs themselves, as the government introduces management reforms to improve productivity and encourage efficient use of resources. SOEs have become more autonomous, and—at least in theory—most now practise independent accounting and take full responsibility for profits and losses.

The government has also forced many mergers and closures, and more are likely over the coming years. Scattered evidence from various parts of the country suggest that this trend continued in 2003. In Changchun, the capital of north-eastern Jilin province, 117 SOEs with assets totalling Rmb22.7bn underwent mergers during the the year, according to a report by Xinhua news agency on December 8th 2003. Xinhua had earlier reported that 10,000 mergers would take place among SOEs in the coming years. Some of the most-talked-about mergers in recent years resulted from a profound restructuring of the aviation industry, which entered its final stages in 2003 (5.3). As part of the reorganisation of the state-owned airline sector, flag-carrier Air China, China Southern Airlines and China Eastern Airlines merged with some smaller regional carriers to form three large groups.

However, not all efforts to streamline the state sector have proceeded smoothly. In the first six months of 2002, authorities closed 1,034 coal mines in northern Shanxi province alone, partly to conform to policies of SOE reform and partly for safety reasons. But anecdotal evidence suggests that many of these coal mines reopened during 2003.

Reform initiatives suggest that state planners intend to focus on turning the largest and most successful SOEs into South Korean-style conglomerates (*chaebol*). The June 2003 merger of China National Pharmaceutical Group and China Medicine Material Group, a producer of traditional medicine, created a conglomerate with Rmb2.14bn in assets. Another *chaebol* experiment that has enjoyed some success was the creation of Shanghai Baoshan Steel Group in November 1998. It sold 1.88bn shares to domestic investors in December 2000. But the government is determined to limit unemployment to maintain social stability in the cities, which will counterbalance the trend for mergers and closures.

The reforms so far have been strengthened by moves to separate government agencies from their business interests in order to improve government professionalism and efficiency. This policy began July 1998, when Jiang Zemin ordered all units of the People's Liberation Army (PLA), the paramilitary People's Armed Police, and police and judiciary departments to extricate themselves from their business interests by end-1998. This was followed by policies in 1999 to separate government agencies below central levels from their business operations.

Many SOEs remain deep in the red for a combination of reasons: decades of poor management, lack of accountability, failed projects imposed by the central government and an onerous social-welfare burden. Nevertheless, the government claims that progress is being made. According to the State-owned Assets Supervision and Administration Commission (SASAC; the main government agency overseeing SOE reform), overall profits of China's 499 key SOEs reached Rmb305.2bn in the first ten months of 2003, up 36.3% from the same period a year earlier.

The legacy of previous poor performance and resulting large debts continues to weigh down the state sector. Companies owe large amounts, in particular to the large state banks. As a result, these banks posted an average bad loan ratio of 21.38% of total loans at end-September 2003. The state banks face a policy goal of lowering their levels of bad loans to those of major foreign banks by 2006, but political pressure from state and local authorities has made it difficult for state banks to call in the debts. By some estimates, they may eventually have to write off up to half their loans.

It the most popular policy formula, debt-equity swaps, special asset-management companies assume debt from selected SOEs in return for an equity stake giving them influence over the management of the companies. By late 2003 China's four asset-management companies had taken over an estimated Rmb1.39trn in debt from SOEs, but local economists have criticised the pace at which they dealt with the assets. The four companies had disposed of just Rmb497.7bn by end-October 2003, leaving more than Rmb890bn still to be handled.

The Company Law of July 1st 1994 is intended to guide the transformation of the largest SOEs into limited-liability corporations. This would open the way for private shareholding, with the state withdrawing to the position of a Western-style investment partner. The law prohibits acting government officials from serving on the board of directors of a transformed company or in its management. Freed from official controls and protection, the newly independent corporations must meet market demand in order to stay afloat.

Legislation for a new bankruptcy law remains stuck in the legislature. Assuming it is ever passed, it would boost reform by establishing clear procedures for winding down terminally ill SOEs. But fears of mass unemployment have hampered implementation, although top central bank officials argue that delays have caused serious losses of state assets. Meanwhile, the government took a step towards bankruptcy reform in April 1999, when it promulgated the Civil Procedure Law. This legislation detailed procedures for how corporate entities are to repay their debts in a bankruptcy.

Some members of the Chinese government argue that moving too fast with reform could actually hurt state assets. This reflects complaints from government officials over the sale of small and medium-sized SOEs at what are perceived as excessively low prices, allegedly hollowing out state assets. A series of published regulations seek to ensure that public-sector assets are not sold at below-market prices to domestic and foreign investors. These include the Provisional Regulations on Several Issues Concerning the Establishment of Foreign-Invested Companies Limited by Shares (effective January 10th 1995).

The provisional regulations established requirements that SOEs and collectively owned enterprises must meet to reorganise into foreign-invested enterprises (FIEs) limited by shares. They must have been in business at least five years and profitable during the three years prior to reorganisation; they must have a foreign shareholder subscribe to at least 25% of share capital in freely convertible currency; and they must have a scope of business in line with investment policies governing FIEs. In effect, the regulations bar foreign investors from certain key industries (in particular, defence production). Previous barriers in industries such as telecoms have begun to fall since China entered the WTO.

Besides SOEs and FIEs (2.2), China's domestic economy permits three major forms of business organisation:

Collective enterprises, originally run by their own workers, were mostly taken under direct state control during the Cultural Revolution. The government has been returning some collectives to their employees, removing them from state planning targets and subjecting them to collective-enterprise taxes and other levies.

Household enterprises are private concerns, generally managed by one individual or a single family, which may employ as many as five workers and two apprentices at a time. Household enterprises may engage in small-scale industry, commerce or services, particularly retailing, repairs, catering and consultancy. They must be organised as sole proprietorships (with the owner retaining personal liability for all debts), and they are governed by regulations that took effect in September 1987.

Private enterprises are defined for legal purposes as privately owned, profit-seeking economic organisations employing at least eight persons. Governed by regulations that took effect in July 1988, they may be organised as sole proprietorships, partnerships or limited-liability companies. Private enterprises may engage in construction projects, communications, commerce, catering and other services. They are specifically excluded from the defence and banking industries and from

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where foreign investment is encouraged in China's less developed inland regions.

Under the regulations, foreign investment projects fall into four categories: encouraged, restricted, prohibited and permitted. Foreign investment projects in the first three categories are listed in detail in the Foreign Investment Catalogue; permitted projects are deemed to be all those not listed. The catalogue allows for some flexibility since companies in the "permitted" category are considered "encouraged" if they export 100% of their output. Similarly, enterprises in the "restricted" category may be upgraded to "permitted" if their exports account for at least 70% of their output.

The 2002 catalogue marked an easing, compared with the 1998 version, since the number of sectors in the "encouraged" category was expanded to 262 from 186; those in the "restricted" category fell to 75 from 112. This liberalisation follows partly from China's concessions to gain entry into the WTO; nevertheless, the schedule for implementing WTO concessions means that certain industries, especially in the service sector, will be opened only after a certain number of years (see below). The main implications of the classification are in terms of the level of government responsible for investment approval (2.1) and the extent of tax exemption available (3.2, 3.3, 3.5). The catalogue also lists various projects for which WFOs are prohibited or for which the state must have a controlling interest.

Encouraged foreign investments, according to the catalogue, include the following:

- projects related to new agricultural technology, construction of energy sources, transport and raw materials for industry;
- projects using new or advanced technology, including those that can increase product quality, save energy and raw materials, raise economic efficiency and alleviate shortages in the domestic market;
- projects that meet international market demand, enhance product quality, open up new markets and increase exports;
- projects that involve integrated use of China's resources or use of renewable resources, involving new technology or equipment for preventing and controlling environmental pollution; and
- projects that can develop manpower and resources of central and western China. In November 2003 the SDRC added to the list projects in north-east China, a geographical area whose economic problems (linked mainly to a moribund state sector) became increasingly apparent during the year.

Some projects in the encouraged category may be eligible for preferential treatment. Both encouraged and permitted foreign investment projects are subject to existing examination and approval procedures for foreign investment.

Restricted categories of foreign investment include the following:

- projects already developed in China, where the technology has already been imported and where capacity can meet market demand;
- projects with an adverse effect on the environment and energy conservation;
- projects involving exploring for and/or extracting rare or precious mineral resources; and
- projects in industries requiring central planning by the state.

Prohibited foreign-investments, according to the catalogue, include the following:

- projects that endanger state security or harm the public interest;
- projects that pollute the environment or endanger human health;
- projects that occupy large tracts of farmland or endanger the security or efficient use of military resources;
- projects that use manufacturing techniques or technologies unique to China; and
- other projects prohibited under state laws and administrative regulations.

To date, the scope of operations allowed for foreign investment, or holding, companies (2.1) includes manufacturing, investment in subsidiaries, purchase of inputs and raw materials for subsidiaries, co-ordination and consolidation of project management, personnel recruitment and training for subsidiaries, market development and consulting to group companies, and provision of product maintenance and technical support. Many foreign investors had assumed that they could convert their representative office into a holding company, which would then perform all their activities. However, foreign investors are finding that they must keep their representative offices to perform their current export-import-related functions, since holding companies are banned from domestic or foreign trade.

An investment enterprise may not act as a general trading company nor directly market products produced by its subsidiary joint venture. Investment companies are also banned from lending to subsidiaries (in China only licensed financial institutions may lend money). Some holding firms circumvent this rule by placing funds with a group company and charging that company a "user fee" for the funds. By law, umbrella firms are allowed only to negotiate loans on behalf of their subsidiaries and to provide collateral and loan guarantees.

Existing foreign-exchange (forex) regulations apparently opened the door to investment companies balancing forex shortfalls and surpluses among their subsidiaries, but the State Adminis-

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Shanghai and Tianjin. China allowed a maximum of four foreign-invested retailing JVs in Beijing and Shanghai, and a maximum of just two in the other locations. After China's entry into the WTO, the cities of Wuhan and Zhengzhou were immediately opened to foreign-invested retail JVs; by late 2003, the geographic scope was to be expanded to all provincial capitals and to the cities of Chongqing and Ningbo, and foreign majority control was to be permitted (although by early 2004 no official announcement to this effect had yet been made). All geographical restrictions and limits on ownership will disappear by end-2004.

In a consensus agreement signed with the United States in June 2001, China also allowed greater foreign access in distribution, by narrowing the definition of chain stores (where foreign participation in JVs is limited to a minority equity share). Prior to this consensus, China had maintained that any retail operation with more than two outlets was considered a chain store and thus could have only minority foreign equity. After the consensus, the minority-share limitations were restricted to stores that sell different types of goods and brands from multiple suppliers and that have more than 30 outlets, and also department stores of more than 20,000 sq metres.

• ***Banking.*** Foreign banks are gradually being allowed greater scope for their investments in both permissible areas of business and geographical scope. Foreign banks, long limited to doing business in local currency with foreign companies (9.2), were allowed to conduct business in the local currency with Chinese enterprises as from December 1st 2003. They are scheduled to gain access to renminbi business with local individuals in late 2006. For renminbi business, the geographical scope was widened beginning December 1st 2002 from the cities of Shanghai, Shenzhen, Dalian and Tianjin to include Guangzhou, Nanjing, Qingdao, Wuhan and Zhuhai. Chengdu, Chongqing, Fuzhou and Jinan were added to the list on December 1st 2003. Beijing, Kunming and Xiamen will be added in late 2004; Ningbo, Shantou, Shenyang and Xian will be added in late 2005; and all geographical limits will be scrapped in late 2006. By late October 2003, 84 of 191 foreign bank branches in China had obtained permission to conduct renminbi business.

It will be cumbersome, however, for foreign banks to take advantage of the full opening in the banking sector mandated by the WTO. The working-capital requirement for doing business under the present level of opening is US$12m, but this will rise to US$72m once the last curbs disappear in late 2006. The WTO agreement also specifies that foreign financial institutions, in order to be allowed to do renminbi business, must have a track record of three years of operations in China and must have been profitable for two consecutive years prior to application.

For foreign banks' business in foreign currencies, all geographical limits disappeared immediately upon accession, and there were no limits on local customers. But some barriers have appeared that hamper exploitation of this opening, including a rule that the State Administration for Foreign Exchange must approve foreign-currency loans by foreign bank branches to Chinese companies.

Non-bank financial institutions should have been able to offer car financing immediately upon accession, but the relevant rules were issued nearly two years after China's entry into the WTO. The China Banking Regulatory Commission issued regulations on October 3rd 2003 for foreign companies wishing to engage in the business, which had previously been open only to state-run banks. The regulations permit both financial and non-financial enterprises to engage in the businesses, but require the largest investor in a car-financing company (with at least 30% of the equity) to be either an automotive firm or a non-bank financial institution. The rules imposed requirements on qualified investors that were considered extremely strict by international standards, including minimum assets of Rmb4bn and business revenue in the previous year of at least Rmb2bn.

• ***Securities.*** In the securities industry, JVs with minority foreign shareholdings have been allowed to engage in fund management on the same terms as Chinese businesses. Minority JVs may underwrite domestic securities issues and underwrite and trade in securities denominated in foreign securities. China has pledged that as the scope expands for local securities firms in the coming years, foreign JVs will automatically enjoy access to the same new areas opened for business.

Upon accession to the WTO, foreign securities companies were allowed to establish fund-management JVs and hold ownership in them of up to 33%. That cap will be raised to 49% by end-2004. Also by late 2004, foreign securities companies will be allowed to establish JVs, with their ownership not exceeding one-third, to engage in underwriting A-shares and in underwriting and trading B- and H-shares, and also government and corporate bonds.

• ***Legal services.*** The government's Regulations for Administration of Representative Office of Foreign Law Firms in China took effect on January 1st 2002. They affect all foreign firms except those from Taiwan, Hong Kong and Macau. To some extent, they relax requirements (for example, they reduce to two from three the number of years a foreign lawyer must have practised abroad to get permission to work in China). But in a number of areas, the regulations place significant burdens on

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States (China's most important trading partner after Hong Kong). The US wants firmer guarantees for investors than are provided in China's other bilateral agreements. Moreover, China wants to use its own courts to settle disputes, whereas the US is pressing for arbitration in a third country.

2.0 Organising an investment

2.1 Basic investment approval. Entering the Chinese market as a foreign company can be a challenging process. Establishing a joint venture (the once-common investment vehicle for foreign investors) generally involves protracted negotiations. Approval procedures for most foreign activity remain complicated, and this is especially true for the increasingly popular wholly foreign-owned venture. Legislation governing foreign investment can be bewildering (and arbitrary, as authorities experiment with new regulations).

Earlier efforts to lighten bureaucratic burdens on foreign-invested enterprises (FIEs) have been reversed in the past few years. China has increased its scrutiny of proposed foreign investment to ensure that only those projects that support national development priorities and can balance foreign-exchange flows are approved. But China's entry into the World Trade Organisation in late 2001 should gradually lead to a more transparent, less cumbersome investment environment.

China's business environment remains demanding in both market entry and day-to-day management. Standard obstacles facing investors include maintaining management control (2.8), obtaining permission to sell on the domestic market (3.5, 5.4), securing domestic financing (9.2), and recruiting skilled managers and workers (10.1). All foreign entities seeking to invest in China must get advance approval. The process for a direct investment depends on which form it takes. The three forms most often used are the wholly foreign-owned venture; the equity joint venture, which is typically used for long-term projects and must register as a legal entity; and the contractual, or co-operative, joint venture.

Wholly foreign-owned venture (WFO). This corporate form is funded entirely with foreign investment and has sole responsibility for profits and losses. It must register as a legal entity, which gives it, among other things, the right to sue other entities or persons in a Chinese court. The WFO has become the most popular investment vehicle since China's entry into the WTO since firms have less need for a Chinese partner to penetrate the market. WFOs are governed by the Law on Wholly Foreign-Owned Enterprises, amended most recently in October 2000, and by related implementing regulations, amended in April 2001.

Equity joint venture (EJV). This corporate form is typically used for long-term projects and must register as a legal entity. EJVs are limited-liability companies, with liabilities limited by the investments. Both the foreign and the Chinese investors contribute capital, obtaining equity and subsequently receiving redistributed profits or sharing losses accordingly. The minimum share that a foreign investor may hold is 25%; there is no maximum. EJVs are governed by the Law on Equity Joint Ventures, amended most recently in March 2001, and by related implementing regulations amended in July 2001.

Contractual joint venture or co-operative joint venture (CJV). This form often is the model adopted for shorter-term projects or build-operate-transfer investments. It can register as a legal entity with limited liability but does not have to. If the company does register as a legal entity, the foreign investor must contribute at least 25% of the registered capital. Typically, the foreign investor provides funding and technology, and the Chinese partner provides land, labour, natural resources, and power and water facilities. Profit redistributions or loss sharing need not reflect the investors' respective contributions; thus, CJVs give both parties significant flexibility in negotiating contracts. CJVs are governed by the Law on Co-operative Joint Ventures, amended in October 2000, and related implementing regulations amended in April 2001.

Apart from these three most widely used investment forms, the Chinese authorities have adopted a series of more recent models:

Foreign-invested company limited by shares (FICLS), also known as a foreign-invested joint-stock company. This form requires registered capital of at least Rmb30m, at least 25% of which must be contributed by foreign shareholders. FICLSs are governed by a separate set of regulations under the Company Law, the Provisional Regulations on Several Issues Concerning the Establishment of Foreign Invested Companies Limited by Shares, which took effect in January 1995. FICLSs form a subclass of joint-stock companies, a corporate form that, together with limited-liability companies, was introduced with China's Company Law, effective July 1st 1994. Joint-stock companies are similar to Western-style public shareholding company.

Limited-liability company. This corporate form is permitted under the Company Law of 1994. It is essentially the same legal type provided for under the existing laws governing wholly foreign-owned enterprises and joint ventures.

Investment, or holding, company. This represents another type of investment organisation that can be either a WFO or a Sino-foreign JV. These can be formed by a foreign company wishing to combine two or more of its JVs or other forms of in-

China Business Weekly newspaper. The same paper reported that the newly established State-owned Assets Supervision and Administration Commission had approved 48 applications for property rights and assets transfers in SOEs between April 2003, when it was established, and October 2003. The deals involved a total of Rmb22.5bn in state-owned assets; private enterprises, either Chinese or foreign, accounted for 83% of the applications.

A legal grey area on foreign acquisitions of local companies was clarified on April 12th 2003, when the Provisional Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors took effect. The rules, published by the Ministry of Commerce (MOFCOM), the State Administration of Industry and Commerce (SAIC), the State Administration of Taxation (SAT) and the State Administration of Foreign Exchange (SAFE), cover two types of acquisitions. "Equity acquisitions" are where foreign investors buy existing shares of a Chinese enterprise or subscribe to new shares issued by a Chinese enterprise. "Asset acquisitions" are where foreign investors buy the assets of a Chinese enterprise.

The rules attempt to create strong barriers against foreign investors establishing a dominant position in the local market through mergers and acquisitions. MOFCOM and the SAIC are supposed to scrutinise applications for deals in which:

- the merger or acquisition will lead to a company controlling 25% of the Chinese market;
- the foreign investor already controls 20% of the Chinese market;
- the foreign investor has assets in China of more than Rmb3bn; or
- the foreign investor has annual sales in China exceeding Rmb1.5bn.

Such deals are not directly prohibited, but the authorities reserve the right to block deals that will lead a company to control too large a share of the market.

The maximum permitted investment resulting from any merger or acquisition is based on the following formula:

- companies with registered capital of less than US$2.1m are allowed to invest 1.43 times that amount;
- those with capital of US$2.1m–5m may invest twice that amount;
- those with capital of US$5m–12m may invest 2.5 times that amount; and
- those with capital exceeding US$12m, may invest three times that amount.

The purchase price must be set with reference to a third-party appraisal of the value of the acquired equity.

Otherwise, the rules reiterate existing Chinese policies on foreign-invested enterprises (FIEs). They specify that FIEs resulting from a merger or acquisition must involve at least 25% foreign investment. They also state that foreign investors contemplating a merger or acquisition must comply with the Foreign Investment Catalogue and its four categories of businesses as they relate to foreign investment (1.5).

An earlier set of rules, from January 1st 2003 and still in effect, allows foreign investors to buy into unlisted SOEs, while keeping certain sectors off limits. The rules (published by SAFE, SAIC and the Ministry of Finance) require central government approval for acquisitions in companies with assets exceeding US$30m, in line with existing rules on investment approval (2.1). Approval is required from the State Council, or cabinet, to acquire companies in "restricted" industries (1.5) or ones that have been conducting debt-equity swaps (1.4).

Separate rules published by the Ministry of Finance and the State Economic and Trade Commission on November 4th 2002 abolished a ban, in place since 1995, against foreign investments in listed SOEs. Under these rules, government-held, non-tradeable shares in listed SOEs may be sold to foreign investors via public tenders. They also require foreign buyers to hold the shares for at least 12 months. Following acquisition of the shares, the SOEs remain classified as domestic companies rather than joint ventures. To help further streamline the state sector, the State-owned Assets Supervision and Administration Commission plans to draft 15 sets of regulations on the management of state assets during 2004.

Press reports indicate that Chinese officials remain wary of foreign dominance of key industries. The government will arrange hearings if an acquisition results in one company controlling more than 30% of the market, if the same industry has seen more than ten mergers within a one-year period and if the acquisition causes total investments by the foreign company in China within a one-year period to exceed US$100m, the *China Securities Journal* said in October 2002. This appears to impose quantitative standards, marking an improvement over the Regulations on Mergers and Divisions of Enterprises with Foreign Investment, in force since November 1999 (5.3). Article 24 of the 1999 regulations merely urged caution against mergers that could hinder competition in a particular business, without giving quantitative benchmarks for maximum market share.

Absent a clear, unified set of regulations on acquisitions, foreign investors have thus far relied on a scattered set of relevant rules. Under existing regulations, procedures vary depending on the form of the venture and of the deal. An EJV partner may also assign all or part of its equity in the venture. Any increase in or disposal of EJV interests is subject to approval by all partners to the venture, the

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rules. In particularly severe cases of criminal acts, punishment is under the Criminal Law.

The SEPA, MOFCOM and the General Administration of Customs issued the Regulations Concerning Strengthened Administration of the Import and Export of Ozone-Depleting Substances in April 2000. These rules are meant to align Chinese legislation with stipulations in the Montreal Protocol, which has given China, along with other developing countries, a 2010 deadline to phase out ozone-depleting substances. Under the regulations, Chinese companies are allowed to trade ozone-depleting substances only with enterprises in a limited group of developing countries allowed by the Montreal Protocol in the phase-out of this trade. Cars sold in China, whether locally manufactured or imported, have not been allowed since January 1st 2002 to have air conditioners that use freon.

China is beginning to take action on lead emissions. With effect from September 1st 2001, the State Council issued regulations banning 187 models of carburettor-equipped vehicles and said it would add more restrictions on vehicles that did not meet national emission standards. Beijing and Guangzhou began banning sales of leaded petrol in 1997; Chengdu, Nanning and Guilin followed suit in July 1999. The effect of these measures, however, is still debatable; a study by the Chinese Academy of Preventive Medicine published in September 2002 showed that 20% of children in Beijing have lead levels exceeding standards set by the World Health Organisation.

The Shanghai municipal government, which is considered the vanguard of environmental protection in China, promulgated the Shanghai Light-Vehicle Emission Standards, effective July 1st 1999, which states that carbon-dioxide emissions by light vehicles may not exceed 3.16 g/cu metre. The municipality also introduced the country's first clean-air tax in December 1996 in a bid to reduce the amount of car emissions choking China's largest city. The regulations set minimum acceptable car-emissions standards, and they provide for fining owners whose vehicles are not within the limits.

In Taiyuan, one of China's most heavily polluted cities, new rules took effect on November 12th 2002 introducing tradeable pollution credits to local companies. Each enterprise in the city is given an annual quota of permissible sulphur-dioxide emissions, which may be sold or saved for later but may not be used in advance. A circular issued on January 30th 2002 by SEPA, the State Economic and Trade Commission, and the Ministry of Science and Technology aims to reduce sulphur-dioxide emissions by 10% nationwide (20% in some heavily afflicted areas) by 2005. Measures include switching away from coal to cleaner energy sources and installing desulphurisation equipment in large factories.

Older national laws govern other areas of environmental protection and pollution control. They include the following:

- The Land Administration Law, from January 1st 1999 (2.5), requires developers to reclaim the same amount of arable land that will be occupied by a prospective project.
- The Law for the Prevention and Control of Environmental Noise Pollution, effective March 1st 1997, gives all enterprises and individuals the right to report or complain to the authorities against any enterprise or individual that creates noise pollution.
- The Law on Prevention and Control of Solid Waste Pollution, effective April 1st 1996, governs the prevention and control of industrial solid-waste pollution, urban-rubbish pollution and toxic-waste pollution.
- The Law on Electric Power, effective April 1st 1996, and the Coal Law also promote responsible environmental practices by encouraging "clean-air" technology to reduce emissions of harmful particles.
- The Law on Atmospheric Pollution Prevention and Control, effective August 29th 1995, governs the prevention and control of pollution related to coal burning, waste gas, dust and air pollution. It outlines the legal responsibilities of companies or units responsible for the pollution.

China has not yet promulgated a set of clear tax incentives to adopt more environmentally friendly production methods. However, the list of industries in which foreign investors are encouraged, published in a revised edition on April 1st 2002, includes a wider range of environmental-protection technology products than previous lists issued in 1998 and 1995 (1.5).

2.5 Acquisition of real estate. Real estate will become a major issue for foreign-invested enterprises (FIEs) in the coming years because of soaring demand for land, for residential as well commercial uses. In China, where all land is owned by the state or collective entities, land-use rights for enterprises come in two forms: "allocated" or "granted". Allocated land-use rights is the more traditional form, under which many state-owned enterprises (SOEs) obtained land in the past. It may not be transferred, leased or mortgaged, and an annual land-use fee is levied.

Holders of granted land-use rights, in contrast, have many of the rights of landowners, including the right to transfer, lease and mortgage the land. A relatively large fee is required to obtain granted land-use right, but annual land-use fees are usually not levied. A regulation issued in March 1996 (Provisional Measures for the Administration of

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The 15 bonded or free-trade zones (FTZs) in particular are becoming popular locations for export-oriented enterprises. They typically offer bonded warehouse facilities, speedy customs clearance and duty-free entry for all goods. Duty-exempt goods are not allowed beyond the zones, and all products manufactured in them must be exported. Chinese customs must approve any exceptions, and appropriate duties must be paid on items that enter the domestic market.

The General Administration of Customs (GAC) responded to local regulation on bonded zones with procedures for customs supervision and control in bonded zones, effective August 1st 1997. The regulations stipulate tariff exemption for imports of machinery and equipment, fuel and spare parts for enterprises in such zones. They also allow enterprises in the zones to export and import without needing licences from governmental agencies (unless other regulations specifically require such licences). The rules allow enterprises in the zones to engage in containerised and bonded transport and act as shipping agents. Local regulation on bonded zones, including a particularly liberal set of rules for the Waigaoqiao Bonded Zone in Shanghai, effective since January 1st 1997 remain in force, but GAC regulations will gradually become standard. They are now implemented almost everywhere, but the regulations are in constant flux. An official with the State Administration of Taxation told the *China Daily* on January 18th 2004 that new incentives are being prepared for bonded zones.

To prepare its case for entry to the World Trade Organisation, the Chinese government eliminated all direct state subsidies to the export sector in 1991. But some other subsidies remain. China's provinces still provide direct subsidies, and the central government continues to make indirect subsidies available when foreign trade corporations or export manufacturers face serious financial difficulties.

4.0 Licensing

4.1 Overview. Under China's regulations on technology imports, foreign companies with patents, trademarks or other intellectual property are free to enter into licensing agreements with Chinese companies. Licensing, used mainly for technology or trademark-related products, has the advantage of limiting a foreign company's exposure, since it need not set up an office or a joint venture (JV). However, a licenser has less control over how its product is priced, marketed and distributed. Furthermore, in practice, greater reliance on centralised decision-making, uncertainty over China's intellectual property protection, and shifting Chinese priorities and policies can undermine deals with Chinese enterprises.

Problems also frequently arise in China because of fundamental differences between foreign licensers and potential Chinese licensees concerning the boundaries of technology transfer. Although Western firms tend to view a licensing agreement as an on-going relationship between licenser and licensee, the Chinese often see technology as a commodity to be purchased and then used freely.

Government policies in this area are in the Regulations for the Administration of Import and Export of Technology, effective January 1st 2002 (4.5).

4.2 Protection of intellectual property. Major laws and regulations on protecting intellectual property rights (IPR) have been issued almost every year since 1982, and in the months before and after China's accession to the World Trade Organisation in December 2001, the National People's Congress (the national legislature) adopted a series of important amendments to existing legislation. The main motivation was to align Chinese laws with the minimum requirements of the WTO's Trade-Related Aspects of Intellectual Property (TRIPs) protocol, which contains general standards for IPR enforcement.

Patents. Amendments to the Patent Law of 1994 were promulgated on August 25th 2000 and took effect from July 1st 2001. This version of the law enhanced judicial review of administrative decisions, broadening it to cover applications not only for inventions but also industrial designs and utility models. Following the amendment, any patent applicant can appeal to the Patent Re-examination Board and, failing that, take the case to court. The amendments also better aligned legislation with WTO principles by deleting special references to foreign-invested enterprises (FIEs) in a part that previously stated the patent rights to inventions made by FIE staff while at work belonged to the FIEs. This right is now extended to all enterprises, foreign-invested or Chinese. The amendments also set penalties for patent infringements, including fines up of to three times illegal proceeds or criminal liability.

Implementing Rules of the Patent Law also took effect on July 1st 2001, along with the amended Patent Law. They seek to bring China up to date on patent regulation by streamlining the allocation of patent rights and by bringing the regime up to international standards. As part of the streamlining measures, the Implementing Rules provide that the relevant departments of foreign trade and of science and technology should jointly allocate patent rights to foreigners. The new rules also state that foreign applicants should pay maintenance fees for patent

lows for fines of 500% of the income derived from illegal price-slashing and gives authorities the right, in serious cases, to close operations of businesses that violate the law.

An amended Pharmaceutical Law, effective December 1st 2001, lets authorities introduce price controls on pharmaceutical products, if deemed necessary. Even for such products where market-determined pricing is allowed, the amended law stipulates that pricing must be fair and not too far out of line with production costs. To ensure implementation of the rules, the law provides that pharmaceutical companies should offer precise and unbiased information about production costs to the authorities.

Amended rules on the operation of wholly foreign-owned enterprises (WFOs), announced on April 12th 2001, removed a stipulation that subjected WFOs to domestic price controls for the part of their production sold inside China. The same rule was abolished for equity joint ventures in regulations announced on July 22nd 2001 (5.4).

The SDRC now imposes price controls on only 13 categories of products, compared with 141 categories a decade ago. Hence, market forces now determine the prices of more than 90% of products traded in China. In general, prices remain controlled only for goods and services deemed essential, such as foodstuffs and tobacco.

The government promised to free coal prices fully in 1994, but it has in fact continued to purchase a fixed supply from money-losing mines at prices higher than its own selling prices to the power, metallurgical and chemical-fertiliser sectors. The remainder may be traded in the free market. Coal, which accounts for three-fourths of China's energy consumption, has been one of the most important commodities under price controls. Over the longer term, however, the government remains determined to continue with price reform in both the energy and the commercial sector.

Price controls generally apply at the ex-factory level, in the form of subsidies to state-owned enterprises to let them produce and sell goods to wholesalers and retailers at artificially low prices. The government has controlled the prices of imports through licensing and quota regimes (11.3), but these are now being revamped to fit China's new status as a WTO member.

6.0 Exchanging and remitting funds

6.1 Exchange controls. Following a string of government measures in the late 1990s to strengthen administrative controls on dealings in foreign exchange, forex outflow gradually subsided, and the Chinese currency, the renminbi, was kept from collapsing. The currency was stable during 2003 and was never allowed to veer far from the Rmb8.28:US$1 mark, despite growing pressure abroad for a revaluation of the currency to reduce the large trade surplus, especially with the United States (1.2, 1.3).

China's forex reserves stood at US$403.3bn at end-2003, up US$116.8bn from a year earlier. Reserves have risen because of boosted exports and recent policies that ban prepayment of foreign debt not explicitly stipulated in a debt agreement, restrict forex trading by domestic bank branches and require financial institutions to conduct more-thorough checks on companies wishing to obtain forex.

The government maintains relatively strict exchange controls, but many foreign businesses believe it will have to simplify procedures, given the rapid increase in foreign trade and investment from China's new status as a member of the World Trade Organisation. The authorities took one step on September 1st 2003, when they introduced new rules allowing local residents going abroad for up to half a year to buy US$3,000 (up from US$2,000); those going abroad for more than half a year may buy US$5,000 (up from US$2,000).

Despite the plethora of restrictions still in place, the general trend over the past decade has been towards a gradual liberalisation of China's forex market. The country reached its most significant milestone in December 1996 when it officially made the renminbi convertible on the current account. In doing so, China agreed to Article VIII of the International Monetary Fund, which prohibits restrictions on payments and transfers for international transactions and multi-currency practices, and other discriminatory measures. Extending this policy, China's exchange authorities closed the country's forex swap markets in December 1998.

China amended its rules on foreign-invested equity joint ventures (EJVs) in July 2001 to be consistent with the partial convertibility of the local currency. This change cancelled a previous requirement that EJVs maintain a balance of forex revenues and expenditures. The rule had become obsolete (and enforcement had ended) after current-account convertibility allowed foreign-invested enterprises (FIEs) to buy and sell forex at local banks for trade purposes.

Current-account convertibility has required China to remove all restrictions on payments of enterprises (including FIEs) for imports, labour and services; repayment of interest on foreign debt; and repatriation of profits by foreign businesses in China. Although current-account convertibility is now a reality, convertibility on the capital account is not expected in the near future.

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Capital-account transactions include those related to direct investment, international loans and securities. Contributing to China's intransigence in this area is its belief that non-convertibility on the capital account helped the country avoid the worst effects of the regional financial crisis of 1997–98.

Chinese officials have repeatedly said that convertibility on the capital account remains a long-term goal, but that it will take place in a gradual, orderly approach. They have announced no timetable for implementing such a reform, and in November 2003 Wen Jiabao, the premier, told the *Washington Post* that it would take "a very long period of time and arduous efforts" before the currency would become fully convertible.

Under the 1996 rules, FIEs may make trade-related forex transactions without prior approval from the State Administration for Foreign Exchange (SAFE). FIEs need only take the related trade documentation to a designated forex bank to obtain hard-currency funds. In exchange for this privilege, however, FIEs must sell all forex earned in excess of a limit set by SAFE in a "basic" forex bank account meant to cover trade-related needs (see below).

The interbank market consists of designated state forex banks and approved foreign banks. These banks operate as members of the China Foreign-Exchange Trading Centre (CFETC) in Shanghai, a national forex-trading centre linked by computer to regional forex-trading centres. The CFETC allows daily fluctuations in the renminbi's forex rate and oversees trading of US and Hong Kong dollars and Japanese yen.

The People's Bank of China (PBoC), the central bank, provides daily quotes of unified rates for the US dollar and other major currencies, based on the previous day's closing prices in the interbank market. Should the rate fluctuate during the day outside a narrow set band, the PBoC maintains a special hard-currency account for intervention.

China issued a slew of measures to improve supervision in 1998–99, following the regional financial crisis. It has added few additional restrictions since then, although the authorities have announced occasional measures to raise regulatory capabilities. They also carry out periodic crackdowns, including on black-market currency transactions and on companies that overstate their imports to obtain hard currency.

Given the continued growth in exports and the rise in forex holdings, there appears to be no immediate threat to the stability of the currency. This gives regulators a rationale for standing pat on controls, and sometimes for relaxing them. For instance, on November 19th 2003 the PBoC and the Hong Kong Monetary Authority (the central bank of the Special Administrative Region) signed a memorandum of understanding allowing Hong Kong banks to accept renminbi-denominated deposits by individuals and tourism businesses, provide renminbi-based credit-card services and exchange renminbi into Hong Kong dollars, or vice versa. Customers face a daily limit of Rmb20,000 that can be exchanged. But in January 2004 these rules had not yet been implemented.

In an important change, SAFE issued new rules, effective October 15th 2002, abolishing a previous system that had allowed only FIEs to maintain limited levels of funds in special forex accounts, while forcing domestic enterprises to sell all hard currency to designated banks. Under the new regulations, all domestic enterprises (including FIEs and wholly Chinese-owned companies) are allowed to hold a basic forex account for current-account or trade-related purposes. The account is capped at 20% of the enterprise's trade-related forex receipts of the previous year. For companies that had no trade-related forex receipts the previous year, the cap is set at US$100,000. Retained forex exceeding this limit must be sold into the local market; if the holder of the account does not do this of his own account, the bank must perform the sale within ten working days. Accounts that have not been active for one year will be closed.

The new rules replace a previous graded system under which the cap was set using a formula determined by the FIEs paid-in capital or export volume. The new system allows a certain degree of flexibility since companies may be allotted a higher cap or allowed to open more than one account—denominated in either US dollars or another foreign currency—if the nature of their business requires it. But in general no locality within China is allowed to let the total cap exceed 25% of trade-related forex receipts of the previous year.

SAFE had previously made a number of smaller changes in the forex regulations. It published rules, effective October 1st 2002, amending restrictions from 1998 that had barred enterprises in bonded or free-trade zones from buying foreign currency. The new regulations list the circumstances when enterprises in free-trade zones may buy foreign currency, including payments in forex to overseas businesses when the enterprises' own forex is not sufficient.

SAFE introduced relaxed rules, effective July 1st 2002, on forex accounts held by FIEs for receiving investment into the enterprise. FIEs no longer need prior approval from SAFE or its local bureaux to convert forex on these accounts into renminbi. New regulations, effective May 1st 2002, strengthened supervision of foreign currency used as capital contribution for foreign investments. The rules require accountants to check the forex registration certificates obtained by foreign investors to

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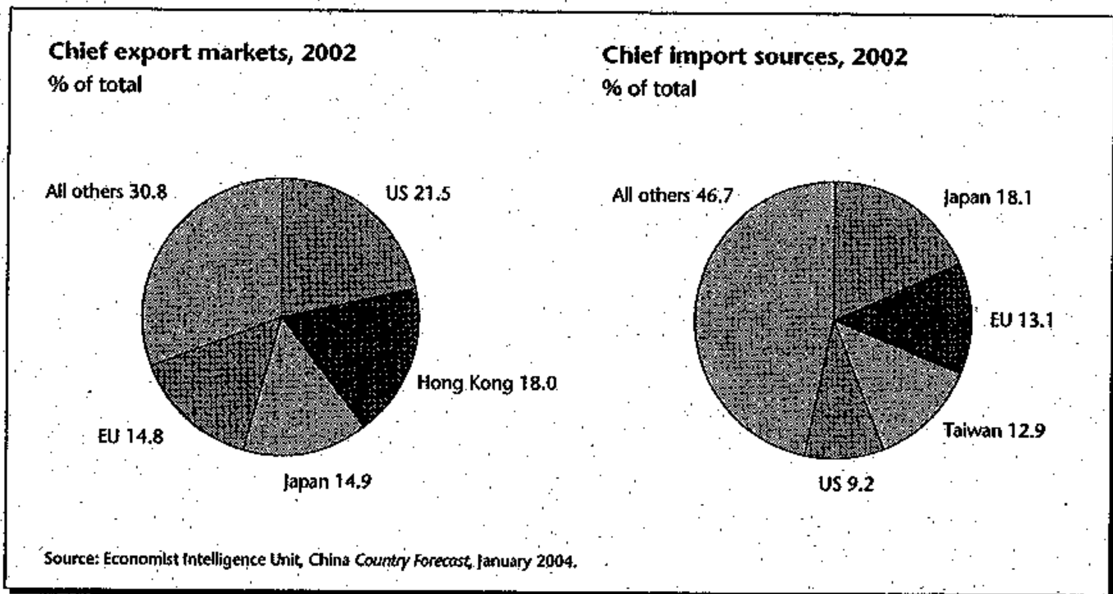

Source: Economist Intelligence Unit, China *Country Forecast*, January 2004.

Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Xinjiang and Yunnan do not pay import or value-added tax for high-technology equipment.

Processing enterprises have paid a security deposit since 1995 for duties and import VAT due if they do not export their finished products, or if they otherwise owe dues to the customs authorities. They can provide a letter of guarantee stating the customs authorities as beneficiary if the enterprises cannot pay their dues. The Bank of China (the nation's largest foreign-currency bank) issues the letter of guarantee based on security from the processing enterprise in the form of, for instance, mortgages and deposits.

The Chinese authorities demand that a company importing products for re-export place a deposit at a local bank equivalent to various percentages of the value of the goods it plans to import. This guards against its possible failure to re-export its finished products within the period provided for in local regulations. A notice issued by the General Administration of Customs on April 14th 2000 sets this deposit at 50% of customs duties and import VAT normally due on products in a "restricted" category (typically, goods that are hard for customs authorities to monitor). This level is set for companies that, on the one hand, have not violated local regulations but, on the other hand, do not belong to a privileged group of enterprises, including those with annual trade volume of more than US$30m. For companies that have previously violated customs regulations, the deposit is a full 100% of the customs and VAT of the goods in the restricted category. The rules about security deposits do not apply to companies established in either bonded or export-processing zones (3.5, 11.5).

11.3 Import restrictions. China has begun to trim its import barriers as a result of its entry into the World Trade Organisation in December 2001. In early 2002 China reduced the number of product categories for which import licences are necessary to 12 from 26. The remaining restricted categories are oil products, natural rubber, tyres, motor vehicles and parts, motorcycles and parts, cameras, watches, crane lorries and their chassis, laser-disk production equipment, controlled chemical products, easily made poisonous chemical products and ozone-depleting substances.

China eliminated all quotas on products such as fibre-optic cable immediately after entering the WTO and will phase out all other quotas (including on those on cars) by 2005. Meanwhile, it will reduce the number of quotas by 15% annually. All licences and quotas will be abolished by 2005.

MOFCOM issued rules on automatic import licensing for foreign-invested enterprises (FIEs) that took effect on January 1st 2002. Automatic licensing applies to goods that the authorities wish to monitor, even if they are not subject to any actual import restrictions. Under the new rules, a licence issued under this system is valid for six months and can be used for up to six shipments. They confirm a previous practice under which imports of equipment and materials needed for a joint venture or wholly foreign-owned investment (such as mechanical equipment, vehicles for use in productive activities, raw materials, fuel, parts, components, elements and accessories) are governed by investment contracts signed with the State Administration for Industry and Commerce and are thus usually exempt from import licences. FIEs' imports of commodities for export-oriented production are also exempt from licences.

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One change of major importance is that major cereals and oilseed are now under a "tariff-rate quota system" with prohibitive tariffs applied to Chinese importers who do not have a state sanctioned quota.

Foreign trade corporations, which operate under a general licence to import commodities, must obtain special licences to import goods outside their approved businesses. FIEs that do not qualify for import-licensing exemptions must submit an import plan every six months to the Quota Licence Bureau of the Ministry of Commerce. After examination, the bureau issues licences for bulk imports of listed items. Under concessions the Chinese government made to enter the WTO, FIEs should be allowed to engage in foreign trade by end-2004 (11.1). The State Development and Reform Commission sets annual import quotas for general commodities.

The Machinery and Electronics Product Import and Export Office under the State Economic and Trade Commission sets and allocates import quotas for machinery and electronic products. Regulations on import and export of technology that took effect on January 1st 2002 clarify application procedures for import licences for various categories of technology (4.5).

New rules on importing audiovisual products, published by the Ministry of Culture and the General Administration of Customs, took effect on June 1st 2002. The rules put the ministry in charge of appointing companies and other units authorised to import such products, and state that it must provide a reason for turning down an import application. The regulations improve on previous rules by also applying to audiovisual products disseminated via the Internet.

Besides licences and quotas, China retains regulatory control over imports via commodity inspection, registration requirements and quarantine rules. An amended Law on the Inspection of Commodity Imports and Exports took effect on October 1st 2002. The law charges the State Administration of Quality Supervision, Inspection and Quarantine with establishing a list of products that must be inspected when crossing the border. Import or export of products that fail the inspection is not allowed. Products on the list for mandatory inspection include those potentially harmful to the safety and health of people and animals, to the environment or to national security. Amendments to the Pharmaceuticals Law, effective December 1st 2001, ban the import of pharmaceuticals that a pharmaceuticals agency under the State Council has found to be unreliable or have serious side effects.

Regulations published by the State Drug Administration in March 2001 require all imported medical equipment to be tested according to standardised procedures before entering the Chinese market. The testing fee can varies by province, though it must be made public and reported to the administration.

11.4 Taxes on exports. China levies no special taxes on exports.

Amendments to China's value-added tax (VAT) law, effective August 1994, clarified that under the VAT system, exports produced by foreign-invested enterprises in China are tax exempt rather than zero rated. Hence, VAT paid on domestically bought raw materials is only partially recoverable. On October 13th 2003 the Ministry of Finance and State Administration of Taxation issued new, lower VAT rebate rates, as from January 1st 2004. Products previously granted a rebate rate of 15% or 17% had the rate reduced to 13%; goods with a 13% rebate rate had it cut to 11%. Exceptions to these general rules reflected the government's industrial priorities. The new rates hit companies dealing with oil and processed wood particularly hard; the rebate rate on their products declined from 13% to 0%. In contrast, for cars and car parts, the rebate rates remained unchanged at 17%.

11.5 Free ports, zones. China has 15 nationally approved bonded or free-trade zones (FTZs). They are in Dalian (Liaoning province); Futian, Guangzhou, Shantou, Shatoujiao, Yantian, and Zhuhai (all in Guangdong province); Fuzhou and Xiamen (Fujian province); Haikou (Hainan province); Ningbo (Zhejiang province); Qingdao (Shandong province); Tianjin (Tianjin province); Waigaoqiao (Shanghai municipality); and Zhangjiagang (Jiangsu province).

To attract foreign trade and finance companies, all FTZs offer duty-free import and storage of goods and materials. Most are also beginning to offer office space managed by foreign companies.

China has also, since early 2000, allowed the creation of export-processing zones (EPZs) as a new kind of geographic area offering special incentives. To maintain control over the spread of the new zones, the government has decided EPZs may be established only within existing economic and technological development zones. On June 21st 2002 the State Council approved eight new EPZs, bringing the total 23: Chengdu (Sichuan province), Dalian (Liaoning province), Guangzhou and Shenzhen (Guangdong province), Hangzhou and Ningbo (Zhejiang province), Hohhot (Inner Mongolia region), Huichen (Jilin province), Kunshan, Nantong, Suzhou and Wuxi (Jiangsu province), Qinhuangdao (Hebei province), Songjiang (Shanghai municipality), Tianjin (Tianjin province), Tianzhu (Beijing municipality), Weihai and Yantian (Shandong province), Wuhan

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Exhibit 6

CHINA'S INDUSTRIAL, INVESTMENT AND EXCHANGE RATE POLICIES: IMPACT ON THE UNITED STATES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

SEPTEMBER 25, 2003

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

OCTOBER 14, 2003

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

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our hearing on September 25, 2003, on "China's Industrial, Investment and Exchange Rate Policies: Impact on the United States." These issues are at the forefront of U.S.-China economic relations, particularly in light of the impact that China's exchange rate and industrial policies are having on global investment trends and on U.S. manufacturing and trade deficits. We are aware that both the Executive Branch and Congress are examining initiatives to address U.S. concerns in this area and therefore we outline here several of the Commission's key findings and recommendations arising from our hearing and research activities to help inform Congressional deliberations.

As you know, the Commission is mandated by law (P.L. 108-7, Division P) to examine, among other areas, China's economic policies and the United States trade and investment relationship with China, including assessing the qualitative and quantitative nature of the shift of United States production activities to China. This latter charge includes examining the relocation of high-technology, manufacturing and R&D facilities to China and the effect of these transfers on United States economic security, employment and the standard of living of the American people.

At our September 25 hearing, the Commission heard testimony from a number of Members of both the House and Senate, including the principal sponsors of various Congressional initiatives designed to address China's exchange rate practices. Representing bipartisan Congressional concerns, these Senators and House Members have introduced differing bills aimed at providing appropriate incentives to the Chinese government to end its apparent mercantilist trade policies, most particularly its artificially undervalued currency, as well as other unfair trade practices such as export subsidies, dumping, and other WTO-inconsistent practices. The Members testified that such practices by China amounted to a forced redistribution of trading and investment balances that violate the principles of free and fair trade embodied in China's WTO accession obligations as well as in its bilateral trade arrangements with the United States and other international agreements, such as the IMF charter. One result of China's unfair trade practices has been its rapid accumulation of foreign exchange reserves, now totaling some $355 billion, the second highest in the world after Japan.

Exchange rate policies. Based on our examination of this issue, it appears clear that China continues to follow a policy of one-way market interventions by the government to maintain its currency at a level that economists estimate is between 15–40 percent undervalued. In this regard, China is purchasing U.S. dollars at an estimated rate of $120 billion per year to prevent appreciation of its currency against the dollar. In assessing causes of the worsening U.S. trade deficit and loss of U.S. manufacturing jobs, some hearing witnesses argued that the lack of net new savings in the U.S. economy, the global mobility of factors of production and/or low labor costs in China were the principal factors. In any event, based on the evidence presented, we believe the inappropriate exchange rate between the Chinese yuan and the dollar is negatively impacting the competitiveness of U.S. manufactured goods and is contributing to a migration of world manufacturing capacity to China and an erosion of the U.S. manufacturing base.

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 (22 U.S.C. Sec. 5304) requires annual reports from the Department of Treasury on foreign countries' exchange rate policies and requires the Secretary to enter into negotiations on an expedited basis with countries found to be manipulating their currencies to gain an unfair competitive trade advantage. Past reports from the Treasury on China have sidestepped this conclusion, which appears now to be inescapable. The Commission believes it is clear that China, in violation of both its IMF and WTO obligations, is in fact manipulating its currency for trade advantage and therefore finds it imperative that the Treasury immediately and forcefully enter into negotiations with the Chinese government to resolve this matter. China's continued maintenance of an undervalued exchange rate with the U.S. dollar will continue to promote

call it what you want, the current situation is unsustainable. There will be very strong reaction, not only in U.S. incidentally but in other countries around the world, to a continued rapid build up of Chinese reserves, trade surpluses and the like. The Chinese have made a huge commitment to joining the WTO, joining the world system, and using trade liberalization—yes, I said trade liberalization in China, which is very profound—to promote their internal domestic reforms. If they wind up with a bunch of trade actions against then, their leadership will have massive egg on its face and be in very bad shape. For that reason too, they will want to avoid it.

Finally, China places a lot of importance on its role in East Asia and its role in the world. They got justified praise for not letting their currency depreciate and not devaluing in the Asian crisis and making it worse. Now they need to make an equally positive contribution to the world economy, global stability and avoidance of trade backsliding, by raising the value of their currency. It would be the best thing they could do for their neighbors, much better than the China-ASEAN free trade agreement that they are discussing in response to the concerns of their neighbors about their competitiveness. It would provide a major step in global leadership terms for the Chinese, which is also very important to them.

In short, we can see how much change is needed: 20–25 percent. There is a clear path to get it: a one-shot revaluation, not some chimera of floating half a decade from now. The Chinese themselves have a major interest in doing it.

I would be happy to answer any questions if there is time to do that.

Discussion, Questions and Answers

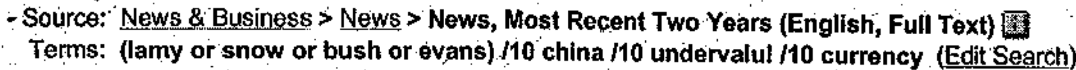
Co-Chairman MULLOY. Are there any questions? Commissioner D'Amato.

Vice Chairman D'AMATO. Thank you very much for your very interesting comment, Mr. Bergsten. Do you think that there is a center of gravity in the Chinese economic elite that essentially not only understands but makes the same argument that you do and reaches the same conclusion? Is there authoritative evidence do you think in writing or at least in commentary that would lead us to think that they agree with your analysis?

Dr. BERGSTEN. I can personally testify that they agree with a lot of it. On my last trip I had dinner with the Minister of Finance, a long meeting with the Governor of the People's Bank of China, and they said explicitly: "We know that the currency is undervalued. We are not even sure it is a good thing that it is undervalued. We have a game plan to correct that situation. We have uncertainty about how much, how to do it, and the timing." In fact, when I asked about the timing, the answer I got was, "Well, maybe sometime around the Olympics" but of course they mean their Olympics, the Beijing Olympics in 2008. I suggested that was a bit too leisurely and one ought to think about doing it more quickly.

But again, to the extent we ask them to float and free the capital account, we are postponing likely action rather than promoting early response to the kind of problems that we are discussing here today.

Exhibit 7



Associated Press Worldstream January 21, 2004 Wednesday

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January 21, 2004 Wednesday

SECTION: FINANCIAL NEWS

DISTRIBUTION: Europe; Britian; Scandinavia; Middle East; Africa; India; Asia; England

LENGTH: 644 words

HEADLINE: Bush again admonishes China for its trade and currency policies

BYLINE: ROBERT FLINT

DATELINE: NEW YORK

BODY:

President George W. Bush gave the Lunar New Year an inauspicious start Wednesday by again chiding the Chinese government over its trade and currency policies.

During a speech in Ohio on domestic policies, Bush reiterated what has become his administration's line: the U.S. wants free trade, but its partners must be committed to fair practices. Bush cited China as an example of a country that engages in unfair trade practices, presumably because the yuan is kept **undervalued** against the dollar.

"We expect countries like **China** to understand that trade imbalances means trade is not balanced and fair," **Bush.** "They have got to deal with their **currency.**"

Nevertheless, the Year of the Monkey, which begins on Jan. 22, augurs well for China. In 2003, the Year of the Goat, China's economy grew at a rate of 9.1 percent, its best performance since 1996 and more than double the pace of growth the U.S. managed last year.

In fact, China's economic success is helping to keep the currency issue a major bone of contention between the two countries. Rightly or wrongly, a number of influential voices in the U.S. have blamed the loss of millions of jobs on competition from China's expansive manufacturing sector.

U.S. politicians, including Bush, have groused about the yuan's peg to the dollar for some time. As the 2004 presidential race heats up, Bush and his Democratic challengers will concentrate more and more on what look to be the hot issues - the economy in general and employment in particular. The loss of manufacturing jobs is a sore point in several states deemed necessary for any victorious presidential candidate to carry.

The Iowa Democratic caucuses gave proof that the economy and jobs are dominant concerns among voters. The two top finishers, Sen. John Kerry of Massachusetts and Sen. John Edwards of North Carolina, are both on record calling for an end to "Chinese trade abuses" and "currency manipulation."

According to the official Web site for Sen. Kerry's campaign (http://www.johnkerry.com), "China, Japan and other nations have purposely kept their currency undervalued relative to the U.S. dollar to promote exports in the U.S. and undermine U.S. products abroad."

Futhermore, "John Kerry believes we must use the full force of the World Trade Organization to take on countries that are manipulating their currency to undermine U.S. exports," the site states.

A corresponding Web site for Sen. Edwards (http://www.johnedwards2004.com) states "China's efforts to keep the yuan undervalued by as much as 40 percent have given their products a substantial price advantage in worldwide markets. Edwards has called for formal steps to end Chinese currency manipulation... ."

While neither Kerry nor Edwards are the worst China bashers among the Democratic challengers, they are using straightforward language, sure to play well with worried factory workers in the American heartland. In contrast, the Bush administration has been restrained in its criticism of China in recent months, most likely because high-level private talks are more effective than public harangues. However, it can't leave Democratic candidates to surf the anti-China wave by themselves.

While Wednesday's speech by Bush won't exactly send shivers down the spines of Beijing's leaders, it does serve as a reminder that dissatisfaction with the yuan's regime isn't going to disappear from the U.S. political scene. While Bush is making a play for domestic votes, he is also signaling to China that U.S. patience with the speed at which China moves to a more flexible currency has its limits.

The Chinese government has always answered that while it will one day give the yuan hard currency status, it needs more time to get its financial system, especially its debt-ridden banks, into shape.

Robert Flint is a news editor for Dow Jones Newswires.

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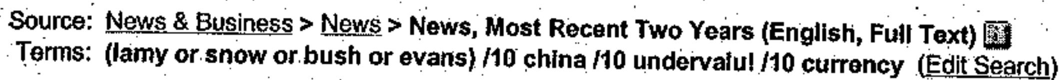

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Associated Press Online November 21, 2003 Friday

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November 21, 2003 Friday

SECTION: FINANCIAL NEWS

LENGTH: 710 words

HEADLINE: Snow to Press China on Currency Policies

BYLINE: MARTIN CRUTSINGER; AP Economics Writer

DATELINE: WASHINGTON

BODY:
The Bush administration would accept some interim steps as China makes the necessary economic reforms to allow its currency to float freely against the dollar, Treasury Secretary John Snow says.

But Snow, in an interview with The Associated Press, left no doubt that a Chinese currency whose value is set by market forces remains the administration's ultimate goal.

"Clearly, we want to hold their feet to the fire," Snow said Thursday. "We are interested in seeing real movement, real action."

Snow said that the currency issue would be raised again when Chinese Premier Wen Jiabao visits the White House in December. The administration is continuing to search for ways to placate U.S. manufacturers angry about the nation's soaring trade deficit with China and the loss of 2.8 million U.S. manufacturing jobs.

As an interim step, Snow said, the administration would be willing to see China decide to revalue its currency - now fixed at 8.28 yuan to the $1 - to some level more closely reflecting its true exchange rate. American manufacturers contend the yuan is 40 percent **undervalued** against the dollar and this has given Chinese products a huge competitive advantage.

Snow said that **China** might also look at possibly pegging the yuan to a group of **currencies** rather than just the dollar.

"There are a lot of things they can look at," Snow said, insisting that the administration is not trying to dictate to China what changes it should make.

"What we are trying to do is have this dialogue and show support as they move" to a freely floating system, China said.

U.S. manufacturers, who have seen one out of every six manufacturing job disappear over the past three years, contend that they cannot wait until China fixes all the problems with its economy that are preventing it from letting the yuan float freely. They have been pushing the administration to encourage China to take an

interim step to revalue its currency before moving to a fully floating rate.

Snow said the increased administration pressure on China, which included a decision earlier this week to impose quotas on three types of textiles and clothing, did not represent a retreat by the administration from its free trade principles as the 2004 presidential election nears.

"I don't know of any administration that has been more forceful, more vigorous in trying to promote the ideas of free trade," said Snow.

He said despite recent problems that have arisen in trying to negotiate a global trade deal following the collapse of World Trade Organization talks in Cancun, Mexico, and current pressures to scale back the scope of a hemisphere-wide free trade area, the administration planned to push forward.

He said the administration's goal was to lower trade barriers to American exports in whatever ways it could, either through global trade deals or hemisphere-wide talks or individual free trade talks. He predicted that the global WTO talks and the 34-nation Free Trade Area of the America talks currently under way in Miami would eventually achieve success. Police fired rubber bullets and tear gas in clashes with demonstrators protesting the talks in Miami on Thursday.

Before the end of the year, the administration will likely announce new free trade deals following on its earlier successes in completing free trade pacts with Singapore and Chile, Snow said.

Snow said the U.S. economy, helped by the tax cuts, was poised for solid growth and stronger job creation in the months ahead. That is politically important to the White House as President Bush tries to fend off attacks from Democratic presidential candidates about his handling of the economy.

On tax policy, Snow said the administration is considering making a fresh push in next year's budget for a new breed of tax-preferred savings accounts that could be used for retirement, college, health care or other purposes.

Snow said the administration was taking another look at the tax proposal, which Bush first made last January, to create two new types of accounts to overhaul a variety of savings plans currently available.

One of the accounts would replace individual retirement accounts and the second would create a "lifetime" savings account that could be used for any purpose.

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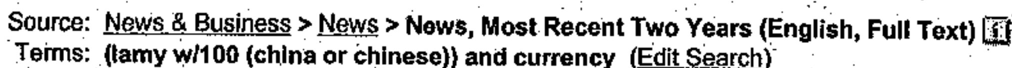

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Agence France Presse December 23, 2003 Tuesday

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December 23, 2003 Tuesday

SECTION: Financial Pages

LENGTH: 433 words

HEADLINE: Euro-dollar stability linked to Asia **currency** developments: Lamy

DATELINE: PARIS, Dec 23

BODY:
Dollar-pegged Asian **currencies,** in particular the **Chinese** yuan, are partially behind current instability in the euro-dollar exchange rate, European Union Trade Commissioner Pasal **Lamy** said here Tuesday.

Lamy, interviewed by radio station RTL, also said that lowering eurozone interest rates was not the way to check the recent surge in the single **currency,** which some analysts warn could dampen eurozone exports and curb growth.

If interest rate differences between Europe and the United States were behind the current imbalance in the euro-dollar exchange rate, "the question of lowering European (interest) rates could be asked," **Lamy** said.

But he added that "everyone knows that it is not because dollar interest rates are not attractive that people are staying with the euro."

Part of the problem, he told the station, lies in Asia.

"Many Asian **currencies** remain pegged to the dollar, and as long as the Chinese yuan, for example, tracks the falling dollar... it will give China an extra measure of competitiveness ... And that needs to be dealt with in the future."

The China Business Post reported Monday that the country's central bank was quietly moving ahead with a plan to peg the yuan to a basket of 10 **currencies** instead of the US dollar alone.

The 10 **currencies** would represent the bulk of China's trade with the rest of the world as well as its main sources of investment, the paper said, citing sources with the People's Bank of China.

At a later phase China could eventually allow a "managed float" that would permit the **currency** to move within a set range.

The report gave no timetable for implementation of either phase and stressed that the potential policy change was still being studied.

But it came as US government financial experts were preparing to visit Beijing next month to discuss possible changes to the existing foreign exchange rate regime.

China has effectively pegged the yuan at about 8.3 to one dollar since 1994 but has come under increasing pressure, particularly from the United States, to revalue.

Washington politicians insist that the yuan is substantially undervalued and contributing to a mounting **Chinese** trade surplus with the US and the loss of American jobs.

But US Federal Reserve chairman Alan Greenspan and many independent economists have rejected those claims.

For its part **China** has publicly maintained that the problem is structural, reflecting its much lower labor costs, but has signalled a certain willingness to investigate a more flexible **currency** regime.

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EU-dollar-euro-forex-Asia-**Lamy**

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Exhibit 10

U.S. DEPARTMENT of STATE

China (includes Tibet, Hong Kong, and Macau)

Country Reports on Human Rights Practices - 2003
Released by the Bureau of Democracy, Human Rights, and Labor
February 25, 2004

(Note: Also see the section for Tibet, the report for Hong Kong, and the report for Macau.)

The People's Republic of China (PRC) is an authoritarian state in which, as directed by the Constitution, the Chinese Communist Party (CCP or Party) is the paramount source of power. Party members hold almost all top government, police, and military positions. Ultimate authority rests with the 24-member political bureau (Politburo) of the CCP and its 9-member standing committee. Leaders made a top priority of maintaining stability and social order and were committed to perpetuating the rule of the CCP and its hierarchy. Citizens lacked both the freedom peacefully to express opposition to the Party-led political system and the right to change their national leaders or form of government. Socialism continued to provide the theoretical underpinning of national politics, but Marxist economic planning has given way to pragmatism, and economic decentralization increased the authority of local officials. The Party's authority rested primarily on the Government's ability to maintain social stability; appeals to nationalism and patriotism; Party control of personnel, media, and the security apparatus; and continued improvement in the living standards of most of the country's 1.3 billion citizens. The Constitution provides for an independent judiciary; however, in practice, the Government and the CCP, at both the central and local levels, frequently interfered in the judicial process and directed verdicts in many high-profile cases.

The security apparatus is made up of the Ministries of State Security and Public Security, the People's Armed Police, the People's Liberation Army (PLA), and the state judicial, procuratorial, and penal systems. Civilian authorities generally maintained effective control of the security forces. Security policy and personnel were responsible for numerous human rights abuses.

The country's transition from a centrally planned to a market-based economy continued. Although state-owned industry remained dominant in key sectors, the Government has set up a commission to help reform major state-owned enterprises (SOEs), privatized many small and medium SOEs, and allowed private entrepreneurs increasing scope for economic activity. Rising urban living standards; greater independence for entrepreneurs; the reform of the public sector, including government efforts to improve and accelerate sales of state assets and to improve management of remaining government monopolies; and expansion of the non-state sector increased workers' employment options and significantly reduced state control over citizens' daily lives.

The country faced many economic challenges, including reform of SOEs and the banking system, growing unemployment and underemployment, the need to construct an effective social safety net, and growing regional economic disparities. In recent years, between 100 and 150 million persons voluntarily left rural areas to search for better jobs and living conditions in the cities, where they were often denied access to government-provided economic and social benefits, including education and health care. During the year, the Government issued regulations that relaxed controls over such migration and expanded the rights of migrants to basic social services. In the industrial sector, continued downsizing of SOEs contributed to rising urban unemployment that was widely believed to be much higher than the officially estimated 4 percent, with many sources estimating the actual figure to be as high as 20 percent. Income gaps between coastal and interior regions, and between urban and rural areas, continued to widen. The Government reported that urban per capita income in 2002 was $933 and grew by 12 percent over the previous year, while rural per capita income was $300 and grew by 5 percent. Official estimates of the number of citizens living in absolute poverty showed little change from the previous year, with the Government estimating that 30 million persons lived in poverty and the World Bank, using different criteria, estimating the number to be 100 to 150 million persons.

The Government's human rights record remained poor, and the Government continued to commit numerous and serious abuses. Although legal reforms continued, there was backsliding on key human rights issues

of passing included newspaper articles and a list of names of persons whose cases had been handled by the courts. Kadeer, her son, and her secretary were arrested in 1999 while on their way to meet a visiting foreign delegation. Kadeer reportedly suffered various health problems in prison. Some foreign observers believed Kadeer was singled out for her activism on behalf of Uighurs and for her husband's involvement with Uighur causes and Radio Free Asia. In December 2002, some of Kadeer's family members were briefly detained and questioned during a visit of senior foreign officials.

Other Uighurs whose work emphasized pride in cultural identity have also been harassed and detained by the Government. In late 2001, the U.N. Human Rights Committee ruled that Uighur scholar Tohti Tunyaz had been arbitrarily detained. He was sentenced in 1999 to an 11-year term for "inciting separatism" and "illegally acquiring state secrets" after he returned to Xinjiang in connection with his research studies on ethnic minorities at the University of Tokyo.

Possession of separatist publications or audiovisual materials was not permitted, and, according to reports, possession of such materials resulted in lengthy prison sentences. The author of a history of the Uighurs that was severely criticized by provincial-level and national authorities in the mid-1990s remained prohibited from publishing or from meeting with foreigners. A Uighur-language press existed in Xinjiang, but it had a very small circulation. During the year, regulations requiring Uighurs to use Mandarin Chinese characters for their names on identification documents were reportedly strengthened.

Han control of the region's political and economic institutions also contributed to heightened tension. Although government policies brought tangible economic improvements to Xinjiang, Han residents have received a disproportionate share of the benefits. The majority of Uighurs were poor farmers, and 25 percent were illiterate.

Section 6 Worker Rights

a. The Right of Association

The Constitution provides for freedom of association. However, in practice, workers were not free to organize or join unions of their own choosing. The All-China Federation of Trade Unions (ACFTU), which was controlled by the Communist Party and headed by a high-level Party official, was the sole legal workers' organization. The Trade Union Law gives the ACFTU control over the establishment and operation of all subsidiary union organizations and activities throughout the country, including enterprise-level unions. The Trade Union Law also allows workers to decide whether to join official unions in their enterprises. There were no reports of repercussions for the small percentage of workers in the state-owned sector that had not joined. Independent unions are illegal.

Although the ACFTU and its constituent unions had a monopoly on trade union activity, their influence over the workplace diminished with the economic reforms of recent years. ACFTU unions were relatively powerless to protect the tens of millions of members who have lost their jobs or had their wages or benefits delayed or cut in the massive restructuring of state-owned enterprises (SOEs). The unions have, however, provided some benefits and reemployment assistance to affected workers. The ACFTU had difficulty organizing in the country's rapidly growing private and foreign-invested sectors, where union membership during the year was estimated to be less than 20 percent. With declines in the state-owned sector and organizational weakness outside the state sector, the ACFTU's membership declined from nearly 100 percent of the urban workforce during the height of the planned economy to approximately 50 percent in recent years. The ACFTU reported a membership of 130 million at the end of 2002, out of an estimated 248 million urban workers.

The existence of an enormous rural labor force, some 490 million out of a total labor force of approximately 750 million, also complicated the organization and protection of workers. Farmers did not have a union or any other similar organization. Of some 130 million rural residents working in township and village enterprises, only a very small percentage were represented by unions. A "floating" migrant labor force of over 100 to 150 million persons has proven especially difficult to organize and protect, although state-run media reported in August that the ACFTU has stepped up a campaign to bring migrant workers into the union. Some of these migrants gravitated to temporary or seasonal low-wage work in urban areas where their residence, under the country's registration system, often was illegal (see Section 2.d.). Many migrants, including substantial numbers of young women, were attracted to the growing private sector where unions were few and where their desire to earn more than they could in rural areas made them easy to exploit.

The ACFTU has shown some interest in adapting its style to the needs of labor in a market economy. Local ACFTU federations have allowed, even facilitated, a few limited experiments in more open union elections and decision-making. These included freely electing, by secret ballot, the leadership of ACFTU-affiliated unions at several foreign-owned factories in Guangdong and Fujian Provinces in 2002 and 2003. The ACFTU also

actively pushed amendments to the Trade Union Law, passed in 2001, that give greater protection to union organizing efforts and legitimize union activity in the private sector, including foreign-invested enterprises, and will now allow migrant workers to become union members. Despite the ACFTU's stated goals to organize these new groups of workers, there had been very limited gains as of year's end.

During the year, the Government took specific actions against illegal union activity, including the detention and arrest of labor activists. In May, Yao Fuxin and Xiao Yunliang, leaders of a large labor protest in Liaoyang City, Liaoning Province, who were detained in March 2002, were sentenced to 7 and 4 years in prison, respectively, based largely on allegations that they had made contact with the CDP in 1998, several years before the workers protests. Many observers believed that the sentences were largely in retaliation for their role in the labor protests.

Other labor activists, detained in previous years, were reportedly still in detention at year's end. Hu Mingjun was serving an 11-year sentence and Wang Sen a 10-year sentence for supporting December 2000 worker protests in Sichuan Province. Shanghai labor dissident Wang Miaogen, detained in 1996, was still being held in a psychiatric hospital. Other labor activists reportedly still in detention included Zhang Shanguang, Li Wangyang, Li Jiaqing, Miao Jinhong, Ni Xiafei, Li Keyou, Liao Shihua, Yue Tianxiang, Guo Xinmin, He Zhaohui, Liu Jingsheng, Peng Shi, Wang Guoqi, and labor lawyer Xu Jian. However, in June, the Government reportedly released Di Tiangui after he served a 1-year sentence for trying to organize a national federation of retired workers.

The country was a member of the International Labor Organization (ILO) and had ratified core ILO conventions prohibiting child labor, including the worst forms of child labor and discrimination in remuneration for male and female workers. At year's end, the Government had not ratified other core conventions regarding the right of association, the right to collective bargaining, and the prohibition against compulsory labor.

At year's end, the Government had not replied to an ILO request for further information in connection with a 1998 complaint brought to the ILO by the International Confederation of Free Trade Unions (ICFTU) alleging the detention of trade unionists and violations of the right to organize. In 2002, the ICFTU submitted another complaint to the ILO alleging repression of independent workers' protests in Liaoyang in Liaoning Province and Daqing in Heilongjiang Province calling attention to the sentencing of two worker activists in Sichuan Province.

The ACFTU had active ties with other national trade union organizations and had a cooperative relationship with the ILO's China office. In 2002, the ACFTU gained a deputy workers' member seat on the ILO's Governing Body, a seat it lost in 1990 during the crackdown following the Tiananmen Square massacre. The ICFTU publicly condemned China for its denial of the right of free association, in particular for arresting labor activists. The ACFTU cooperated with the U.N. Development Program on a program, part of which was designed to assist unions to adapt to a new labor relations model.

b. The Right to Organize and Bargain Collectively

The Labor Law permits collective bargaining for workers in all types of enterprises; however, in practice, genuine collective bargaining still did not occur. Under the law, collective contracts are to be developed through collaboration between the labor union (or worker representatives in the absence of a union) and management, and should specify such matters as working conditions, wage scales, and hours of work. The law also permits workers and employers in all types of enterprises to sign individual contracts, which are to be drawn up in accordance with the collective contract.

The country's shift toward a market economy and changing labor-management relations created pressures for collective bargaining that would include more genuine negotiations and take workers' interests into greater account. The Trade Union Law specifically addresses unions' responsibility to bargain collectively on behalf of workers' interests. However, given the non-democratic, Party-dominated nature of unions, collective bargaining fell far short of international standards. Workers had no means to formally approve or reject the outcome of collective contract negotiations and, without the right to strike, only a limited capacity to influence the negotiation process.

In the private sector, where official unions were few and alternative union organizations were unavailable, workers faced substantial obstacles to bargaining collectively with management. Workplace-based worker committees, expected to guide union activities and serve as the vehicle for worker input into enterprise policies, were common. However, in SOEs, many were little more than rubber stamps for deals predetermined by enterprise management, the union, and the CCP representative.

The Trade Union Law provides specific legal remedies against anti-union discrimination and specifies that

union representatives may not be transferred or terminated by enterprise management during their term of office. These provisions were aimed primarily at the private sector, where resistance to unions was common. The degree to which these provisions were enforced was unknown. Anti-union activity was virtually unknown in the state-owned sector.

Neither the Constitution nor the law provides for the right to strike. The Trade Union Law acknowledges that strikes may occur, in which case the union is to reflect the views and demands of workers in seeking a resolution of the strike. Some observers have interpreted this provision to offer at least a theoretical legal basis for the right to strike. However, government treatment of worker protests as illegal demonstrations established that there was still no officially accepted right to strike. In addition, no other types of planned worker action were allowed.

During the year, the profound economic and social changes affecting workers continued to produce labor-related disputes and worker actions. These included spontaneous and on-the-job protests, most of them directed against SOEs, usually over actual and feared job losses, wage or benefit arrears, or allegations of owner/management corruption in enterprise restructuring. The Government took swift action to halt protests. Police detained protest leaders and dispersed demonstrations, usually with minimum force. They sometimes subsequently offered payments that met at least a portion of protestors' demands. The most noteworthy labor protests in recent years occurred in the spring of 2002 in the northeastern region of the country, particularly in Liaoyang, Liaoning Province. In the Liaoyang protests, thousands of organized workers and sympathizers demonstrated for a number of days, protesting alleged corruption in the closure of a major local SOE, the loss of jobs, and wage and benefit irregularities. As a consequence of the protests, four worker leaders were arrested. Of these, Yao Fuxin and Xiao Yunliang were convicted on subversion charges and sentenced in May (see Section 6.a.). After the protests, the former manager of the SOE was sentenced to 13 years on smuggling charges. The local Government fired Liaoyang's police chief and demoted a top Party official in the city. Work stoppages at private companies were far fewer than in SOEs but did occasionally occur.

The Labor Law provides for mediation, arbitration, and court resolution of labor disputes. Under these procedures, cases are to be dealt with first in the workplace, through a mediation committee, then, if unresolved, through a local arbitration committee under government sponsorship. If no solution is reached at this level, the dispute may be submitted to the courts. According to Ministry of Labor and Social Security statistics for 2002, 51,000 labor disputes were settled through mediation, and 184,000 disputes involving 610,000 workers were submitted to arbitration, increases of about 19 percent and 31 percent, respectively, over 2001 figures. Of these cases, 11,000 were collective labor disputes, and a vast majority of cases, 179,000 or 91 percent, were resolved.

Observers differed over the effectiveness of these dispute resolution procedures. Workers reportedly had little trust in the fairness of workplace mediation. They viewed unions, which played a major mediation role, as inclined to favor management. Workers favored arbitration over workplace mediation, although they often looked with suspicion on the local government role in the process.

Laws governing working conditions in Special Economic Zones (SEZs) were not significantly different from those in effect in the rest of the country. Lax enforcement of these laws by provincial and local officials was a serious problem in the SEZs, as in other parts of the country. Wages in the SEZs and in the southeastern part of the country generally were higher for some categories of workers than in other parts of the country because high levels of investment have created a great demand for available labor. As in other areas of the country, officials acknowledged that some investors in the SEZs were able to negotiate "sweetheart" deals with local partners that bypassed labor regulations requiring the provision of benefits and overtime compensation. Some foreign businesses in the SEZs had ACFTU-affiliated unions, and management reported positive relations with union representatives, in part because the ACFTU discouraged strikes and work stoppages.

c. Prohibition on Forced or Bonded Labor

The law prohibits forced and bonded labor, and the Government denied that forced or bonded labor was a problem; however, forced labor was a serious problem in penal institutions. Citizens were consigned to penal labor institutions, without judicial process (see Section 1), that by law and public policy utilized labor as a means of reform and reeducation. Detainees in custody and repatriation centers, before that system was abolished in June, as well as reeducation-through-labor detainees and prisoners and pretrial detainees in the regular prison system, were required to work, often with little or no remuneration. Diplomatic observers generally were unable to gain access to reform institutions to evaluate allegations about the treatment of prisoners. In some cases, prisoners worked in facilities directly connected with penal institutions; in other cases, they were contracted to nonprison enterprises. Facilities and their management profited from inmate labor.

In 1992, the U.S. and Chinese Governments signed a memorandum of understanding (MOU), followed by an implementing statement of cooperation (SOC) in 1994. These agreements expressed the intention of the governments to cooperate to assure that Chinese prison-made products were not exported to the United States. However, Chinese cooperation under the MOU and SOC has been poor. Regular working-level meetings were held in 2002, but a scheduled prison visit and further cooperation were suspended in 2003 due to SARS; no prison visits took place during the year. Although monthly meetings resumed in December 2003, the backlog of cases remained substantial at year's end. The Government continued to exclude explicitly reform- and reeducation-through-labor institutions from the agreements.

The Government prohibits forced and bonded labor by children, but some child trafficking victims were reportedly sold into forced labor (see Section 6.f.).

Status of Child Labor Practices and Minimum Age for Employment

The law prohibits the employment of children under the age of 16, but the Government had not adopted a comprehensive policy to combat child labor. The Labor Law specifies administrative review, fines, and revocation of business licenses of those businesses that illegally hire minors. The law also stipulates that parents or guardians should provide for children's subsistence. Workers between the ages of 16 and 18 were referred to as "juvenile workers" and were prohibited from engaging in certain forms of physical work, including labor in mines.

The Government continued to maintain that the country did not have a widespread child labor problem and that the majority of children who worked did so at the behest of their families, particularly in impoverished rural areas, to supplement family income. Child workers in rural areas appeared to work primarily for township and village enterprises and in agriculture. In urban areas, they often worked as menial and street laborers. Some observers believed that coalmines, which often operated far from urban centers and out of the purview of law enforcement officials, also occasionally employed children. The Government argued that the existence of a large adult migrant labor force, often willing to work long hours for low wages, reduced the attractiveness of child labor for employers.

Some students worked in light industrial production within or for their schools. In March 2001, an explosion in Jiangxi Province at an elementary school that was also used to manufacture fireworks killed 42 persons, most of them schoolchildren who worked to assemble the fireworks. After parents of the children spoke to the press, the Government took disciplinary action against local officials who had attempted to cover-up the case as an attack by a "mad bomber." Provincial officials moved to tighten controls over Jiangxi's economically important fireworks industry. This incident may have served as a catalyst for greater government acknowledgement of the problem of child labor. In the autumn of 2001, the Government announced the formation of a multi-agency commission to study the issue. The commission failed to produce a public report. In October 2002, the State Council issued a regulation clarifying existing child labor prohibitions.

e. Acceptable Conditions of Work

The Labor Law provides for broad legal protections for workers on such matters as working hours, wages, and safety and health. The Trade Union Law invests unions with the authority to protect workers against violations of their legal rights or contractually agreed conditions of work. The Law on the Prevention and Treatment of Occupational Diseases, and the Production Safety Law identify responsibilities for work-related illness and accidents, and provide for specific penalties for violation of the law. However, there remained a substantial gap between the law's formal provisions for work conditions and the actual situation in the workplace.

There was no national minimum wage. The Labor Law allows local governments to determine their own standards for minimum wages. Local governments generally set their minimum wage at a level higher than the local minimum living standard but lower than the average wage. Widespread official corruption and efforts by local officials to attract and keep taxpaying, job-producing enterprises that might otherwise locate elsewhere undercut enforcement of the minimum wage provisions.

The Labor Law mandates a 40-hour standard workweek, excluding overtime, and a 24-hour weekly rest period. It also prohibits overtime work in excess of 3 hours per day or 36 hours per month and mandates a required percentage of additional pay for overtime work. However, these standards were regularly violated, particularly in the private sector. They were particularly ignored in enterprises that could rely on a vast supply of low-skilled migrant labor. In many industries such as textile and garment manufacturing, compulsory overtime reportedly was common, often without overtime pay. During the year, auditors found that some factories routinely falsified overtime and payroll records. There also were reports of workers being prevented from leaving factory compounds without permission.

Exhibit 11

CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

ANNUAL REPORT

2003

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

OCTOBER 2, 2003

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sponsored a Beijing conference on the role of criminal defense lawyers. The conference included lawyers, academic experts, judges, and law enforcement officials from both the United States and China, and addressed a range of topics related to criminal defense.

III(b) Protection of Internationally-Recognized Labor Rights

FINDINGS

- China's poor record in protecting the internationally-recognized rights of its own workers has not changed significantly in the past year.
- Workplace health and safety is poor in many Chinese workplaces. Fatalities among mine workers are especially high. Although China now has better laws to improve health and safety standards, government authorities lack the will or capacity to enforce the law.
- Restrictions on the ability of Chinese workers to form and join independent trade unions limit workers' ability to assert not only their internationally recognized labor rights but also their rights under China's Constitution and laws.

Overview

The Commission's 2002 Annual Report found working conditions and respect for basic, internationally recognized worker rights in China to be well below international norms in numerous respects. It also found that working conditions and respect for worker rights in China were frequently in violation of China's own laws, especially those governing wages and overtime pay, work hours and overtime hours, and workplace health and safety. Over the last year, these conditions have remained largely unchanged.

The Chinese government continues to deny its citizens the right to freely organize and to bargain collectively and continues to imprison labor leaders and actively suppress efforts of workers to represent their own interests. Worker unrest continued in 2003, often in association with the closing of state-owned enterprises. Although no reports reached Western news media about massive worker demonstrations of the scale that occurred in northeast China in 2002, numerous reports in 2003 described smaller-scale protests by workers whose rights were ignored by management at collapsing state-owned companies. The government suppressed these protests with the same techniques used in northeast China in 2002. In addition, the Chinese government continues state-sanctioned discrimination against migrant workers and practices forced and prison labor. Child labor continues to be a significant problem in China.

International Labor Organization

Through the International Labor Organization (ILO), of which China is a member, most nations of the world have acknowledged the existence of a basic floor of international standards for the rights of workers—the rights to associate and to bargain collectively, elimination of forced labor, effective abolition of child labor, and nondiscrimination. The ILO's Declaration on Fundamental

Principles and Rights at Work re-affirms the commitment of ILO Members to those basic rights.

Guidance on the full scope of the rights and principles enumerated in the Declaration is provided by the ILO's eight core conventions.[109] Many countries, including the United States, have not ratified all of the ILO's core conventions, but the Declaration states, "even if they have not ratified the [ILO] Conventions . . . [ILO Members] have an obligation arising from the very fact of membership in the Organization to respect, to promote and to realize, in good faith and in accordance with the Constitution, the principles concerning the fundamental rights which are the subject of those Conventions."

With the exception of the ILO provisions relating to freedom of association and collective bargaining, Chinese labor law generally incorporates the basic obligations from the ILO's eight core conventions. The Chinese government's failure to enforce existing laws, however, makes this incorporation largely irrelevant when considering actual working conditions in China.

Freedom of Association and Collective Bargaining

The Chinese government denies its citizens the freedom to associate and forbids them from forming independent trade unions. The government has made no progress in the past year toward respecting this right, and continues to use the All-China Federation of Trade Unions (ACFTU) as a tool of Communist Party control of union activity. China continues the practice of imprisoning labor leaders as a means of repressing independent labor activity.

The inability of Chinese workers to organize independent labor unions prevents them from defending their own interests. For working conditions in China to improve significantly, workers require greater freedom of association in law and in practice. In the short term, however, greater awareness by Chinese workers of the limited rights already available to them could yield some workplace improvements.

Workers and labor experts in China and elsewhere recognize that the ACFTU, the only legal labor organization in China, is ineffective as a voice for worker rights. Article 11 of China's Trade Union Law states that all basic level unions must be approved by the next higher level of union, ensuring state control of any locally-formed worker organizations. In testimony at a July 2003 Commission roundtable, Phil Fishman of the AFL–CIO stated that ". . . institutionally the ACFTU is a creature of the Chinese state and Communist Party and is obligated by its own rules to act as a transmission belt for Party and state policy." [110]

Chinese workers are generally unaware of the limited rights to organize already available to them. These rights are contained in the Trade Union Law but are implicit rather than explicit. The law requires all worker organizations to affiliate with the ACFTU, but does not state explicitly that the ACFTU must be involved in the establishment of new unions.[111] This allows, in theory, for workers to organize a union chapter and then seek affiliation. This has not, however, happened to date, and would likely be very difficult in practice.

Han Dongfang, Director of the *China Labour Bulletin*, a Hong Kong-based publication, testified to a November 2002 Commission roundtable that government efforts to improve workplace safety had been ineffective due to a lack of worker involvement. Han added that a new workplace safety law (effective November 1, 2002) calls for workers to be involved in workplace safety, which suggests the possibility of workers organizing for specific purposes.[112]

Similarly, at an April 2003 Commission roundtable, Doug Cahn, Vice President for Human Rights Programs at Reebok International, Ltd., described Reebok-facilitated elections for worker representatives at two Chinese factories.[113] Cahn described the elections as free, open and fair, and consonant with Chinese labor law. These elections suggest that existing Chinese law may be sufficiently flexible to allow workers to select their own leaders in some circumstances, notwithstanding legal limits on the creation of independent labor unions. Cahn also indicated that it is too early to predict whether the Reebok elections will affect the workers' ability to assert their rights in the future. Without training for elected leaders on how to represent workers' rights and claims, these organizations are unlikely to drive significant change. Moreover, given the practical limitations on establishing independent worker organizations, the elections sponsored by Reebok may be seen as a small but positive step forward, but they do not represent a significant advancement of freedom of association in China. Without independent labor unions and the ability of workers to organize freely and represent themselves, collective bargaining cannot truly be said to exist in China.

Legal action against workers who attempted to establish independent worker organizations continued over the past year. In May 2003, a court in Liaoyang, Liaoning Province convicted labor protest leaders Yao Fuxin and Xiao Yunliang of subversion and sentenced them to 4 and 7 years in prison respectively. The pair led peaceful protests in Liaoyang during March 2002 and were detained before trial for almost a year. In June 2003, their appeal of the convictions was denied. Neither family was notified of the appeal proceedings, nor were their lawyers present.

Working Conditions

Over the past year, generally poor working conditions in Chinese factories have not changed significantly. 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.

Workplace Health and Safety

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. Mines continued to be the most hazardous of China's many dangerous workplaces. In a meeting with officials of the Department of Labor's International Labor Affairs Bureau (ILAB) in August 2003, officials of China's State Administration for Work Safety indicated that 6,995 Chinese miners

died on the job in 2002. At a Commission roundtable held in November 2002, Han Dongfang of the *China Labour Bulletin* cited Hong Kong press reports that 100,000 Chinese workers died in Chinese workplaces between January and September 2002.[114]

Government bodies do not enforce existing safety regulations in most Chinese workplaces, meaning that many Chinese-made products purchased in the United States are produced under conditions that would be unacceptable to most Americans. Discussing a new health and safety law and the chemical handling directives that went into effect in November 2002, labor scholar Trini Leung told a Commission roundtable that, "This law is the culmination of over a decade of efforts and resources . . . [and] 1 week into its effective date, it's not too early to announce that this statute will, just like hundreds of other laws in China . . . become another meaningless document sitting on the shelf while violations go from bad to worse." [115]

Wages and Working Hours

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. According to Chinese labor law, the regular workweek is limited to 8 hours per day, 5 days per week (40 hours).[116] Overtime is limited to 3 hours per day and 36 hours per month unless special permission is sought and certain conditions met. Overtime on regular workdays is to be paid at 150 percent of base pay (time and a half), 200 percent on weekends (double time), and 300 percent on national holidays (triple time).[117] Numerous conversations between Commission staff and Chinese, Hong Kong and U.S. NGOs involved with labor issues, as well as with U.S. and European companies, indicate general agreement that workers in China are frequently required to work in excess of legally allowed overtime, and that overtime pay is frequently calculated at the same rate as work performed during regular work hours, rather than at mandated premium rates.

Codes of conduct adopted by most U.S. companies require workweeks not to exceed 60 hours per week, including overtime. Although this 60-hour workweek exceeds China's legal limits, many companies report significant difficulty in persuading their suppliers to adhere even to this standard.

Prison and Forced Labor

Working conditions in many privately owned Chinese factories are such that workers cannot refuse overtime, but observers disagree whether this practice meets the definition of forced labor. However, forced labor in other forms is common in China. Called *laojiao* and *laogai* in Chinese (depending whether the prisoner is detained for "re-education through labor" by administrative means without trial or forced to engage in labor while serving a formal criminal sentence), forced labor is an integral part of China's prison system. As discussed in Section III(a), public security authorities have the power to place detainees in "re-education through labor" facilities without trial. Although *laogai* has been officially purged from the Chinese criminal code, China's criminal justice system

continues to force convicted offenders to work in prison facilities. Unlike U.S. prisoners, Chinese prison laborers often cannot refuse to work, and work under conditions that violate China's own law and international labor standards.

Section 307 of the Tariff Act of 1930 (10 U.S.C. § 1307) prohibits the import of goods made by prisoners into the United States. To promote effective enforcement of Section 307, the United States-China Relations Act of 2000 created a "Task Force on the Prohibition of Importation of Products of Forced or Prison Labor from the People's Republic of China." To date, the Task Force has been concerned principally with implementation of a 1992 U.S.-China Memorandum of Understanding, which allows U.S. Customs to request permission to visit Chinese prisons suspected of producing goods for the U.S. market. A 1994 bilateral Statement of Cooperation clarified procedures to be followed in requesting and making these inspections.

After 1994, Chinese authorities stopped agreeing to inspection requests from U.S. Customs. However, the Chinese government agreed in mid-2002 to cooperate in clearing the backlog of old requests and allowed a visit to a site suspected of producing goods for the U.S. market in the mid-1990s. Although as a result of the lack of Chinese cooperation, several years had elapsed since the original allegation was made, U.S. Customs inspectors found no evidence that the facility had been producing for export to the United States, or that it had been used recently for production of any kind. Currently, the U.S. government counts a total of 18 outstanding requests for prison site visits, most of which were filed between 1995 and 2002. The integration of the U.S. Customs Service into the new Department of Homeland Security delayed efforts to continue the inspections process. The Task Force was not reconstituted until mid-2003.

Goods made in Chinese prisons probably do not constitute a large percentage of overall Chinese imports into the United States. Whatever the scale of the problem, the model of enforcement set out by the 1992 Memorandum of Understanding is inadequate to address the questions raised by complaints. Enforcement of Section 307 currently depends on private individuals or organizations lodging complaints with U.S. Customs. A producer's competitors have the greatest motivation to lodge complaints, but they often lack credible evidence to support their allegations.

State-Owned Enterprises

The collapse of China's state-owned enterprises continued during late 2002 and 2003. Between 1998 and 2002, an average of more than 6,000 companies in China went bankrupt each year, most of them state-owned enterprises.[118] Shrinking employment rolls affect women disproportionately since managers tend to assume that unemployed women will be supported by their husbands, and therefore lay them off first. Significant worker unrest has grown out of the mass dismissals following these bankruptcies, but few details of these protests exist outside China. As a political party nominally constituted to represent and advance the interests of peasants and workers, the Communist Party views worker unrest with particular alarm.

Exhibit 12

A "Race To the Bottom"

Globalisation and China's labour standards

Anita Chan

THE Chinese government rejoiced on the occasion of gaining World Trade Organisation membership in November 2001. There was an expectation in Peking that once the country became integrated into the world economy, it would be on the right track to attain economic prosperity. There might be some bumps along the way: some industries and agriculture would suffer, affecting employment, but as a whole, it was predicted, China would gain. Employment has been a major concern in China, and the government's best sell was that foreign investment would increase and the labour-intensive manufacturing sector would gain: according to one estimate, 2.8 million additional jobs in textiles and 2.6 million jobs in the garment trade, as the constraints of quotas for garments and textiles end [1].

As predicted, foreign investment has been flowing into China in the past year at the expense of its South-East Asian neighbours and the tiger economies of Hong Kong, Taiwan, Korea and even Japan. Hong Kong and Taiwan have been the nurturers of Chinese export industries for more than a decade, only to discover now that some of their own industries are being "hollowed out" [2]. As one observer, William Greider, describes it, China is "sucking away" jobs. "Globalisation", he writes, "is entering a fateful new stage, in which the competitive perils intensify for the low-wage developing countries. [...] In the 'race to the bottom', China is defining the bottom" [3].

In other words, though employment in the low-wage industries in China may be expanding, the wages of the workers in these industries are not rising, and for many of them have been falling. What within the Chinese system allows it to lead in this race to the bottom in labour standards? [4] First, let us examine the empirical evidence showing that, when compared with other developing export-oriented countries, wages in China are very low relative to the cost of living.

Chinese wages in comparative perspective

There is a popular image that the global divide in competition in world trade is between the developed and underdeveloped countries. I would like to argue here that increasingly the competition, particularly in the labour-intensive industries, is largely among countries in the developing world. The intense competition in wages among these countries is well illustrated by Figure 1, which shows the minimum legal wage in a number of countries around the world as of 1999.

This shows an enormous gap between the minimum wage in the United States and those of developing countries in Asia and Central America—with the US minimum wage at least twenty times higher. Faced by cheap labour abroad in this era of global production, labour-intensive industries are basically finished in the US and in most other high-wage nations. Such goods continue to be produced there only to a marginal extent by using illegal immigrants [5] and home workers [6], "sweated" at a wage well below the legal minimum wage.

Competition in these labour-intensive industries lies instead today among the countries of the third world. All of the minimum legal wages in the developing countries in Figure 1 hovered around US$30-50 a month. This is equivalent in China to 240-400 yuan a month. The legal minimum wage in Shenzhen, the Chinese city with the highest minimum wage, was equivalent to only US$42. China has set its minimum wage standards very low, to the point that it is even competitive with Vietnam and Cambodia, two countries where the cost of living is lower than in China. In Mexico, El Salvador and Nicaragua, the wage levels are slightly higher than Asian wages, but this competitive disadvantage is largely cancelled out by the proximity of Central America to the American market.

able to hold down wages by turning a blind eye to violations of China's own labour regulations and laws. The central government normally does not intervene.

Competition within China between different regions exacerbates the problem of low wages. And the central government has intervened in a way that encourages even lower pay. Though migrant workers' wages in Guangdong province are very low, the central government has been worried that Guangdong is pricing itself out of the international market. The government therefore has started to encourage foreign capital to move inland, to places where the pay is even lower. The owner of an Australian toy company who sources some of her merchandise from China noted enthusiastically to me this past year that she is now contracting toy production at factories further north and away from big cities. The products, she said, are just as good and cheaper.

Mexico: China's main competitor

The geographic race to the bottom that operates within China also operates in an international context. In the 1990s China's main competitor for the American garment market was Mexico, on the other side of the globe [13]. Since the signing of the North American Free Trade Agreement (NAFTA), Mexico has gained a large number of new clothing factories. Today China and Mexico are competing neck and neck for the American market, each supplying around 15% of all apparel imports to the US. Mexico enjoys two substantial advantages over China: it is next door to the US (and hence can meet a faster turnover rate for orders) and it enjoys an absence of quota restrictions due to NAFTA. As a result, Asian investors who serve as the subcontractors for the name-brand Western multinationals—and these are particularly South Koreans and Taiwanese—became increasingly active there in the 1990s, even moving apparel production out of Asia to Mexico. Along the US-Mexican border assembly plants called *maquiladoras* have mushroomed, employing about a million migrant workers in various labour-intensive industries. This number is still small compared to the 12 million in Guangdong province alone, but it represents a 150% increase in Mexico since 1990 [14].

As in China, expansion in employment does not mean rising wages for Mexican migrant workers. The minimum legal wages there are almost double that of Shenzhen, and this produces pressures on Mexican wage trends. In the manufacturing sector, real wages dropped by 20% during the 1990s. According to the International Labour Organisation's estimate, the migrant workers' wages in Mexico's apparel industry shed 28% of their purchasing power in the period between 1994 and 1999.

Despite this drop in real wages, the *maquiladoras* recently have been losing ground. As trade barriers continue to fall due to the WTO, the middleman firms from Taiwan and South Korea have begun shifting production back to Asia, particularly China. The numbers of *maquiladoras* swelled from 120 in the 1970s to 3,700 in 2000, but have dropped by 500 factories since then [15]. Pressures are therefore tightening on Mexican enterprises to more vigorously compete with China's long working hours and bargain-basement wages. This also explains why Mexico was the last country to sign a trade agreement with China, delaying China's entry into the WTO. Mexico knew that when the trade barriers are removed, it would have much to lose. But the international pressure was too great for Mexico to stand its ground.

China's pass system—the drive to the bottom

There are numerous reasons why Chinese wages can be kept so competitive compared to other countries. First, it has an almost inexhaustible supply of cheap labour from the countryside. Second, the decentralisation and deregulation in wage-setting under China's economic reforms has enabled local governments to turn a blind eye to labour exploitation. Third, there is no autonomous union movement in sight in the foreseeable future to fight to preserve wage levels, and the Chinese government is intent on making sure that none is allowed to arise.

There is also a fourth fundamental reason—China's so-called *hukou* system, or household registration system, which prevents an uncontrolled rural-to-urban influx of population. This works in similar ways to the pass system under South Africa's former system of apartheid. To be sure, the two systems differ markedly from each other in origin and ideology. The South African pass system was intertwined with a history of racism, colonialism and the development of South African capitalism, all of which favoured the control of movement of African people to provide greater political security and enhanced efficiency in the use of black labour. The ideology on which the system was based was white supremacy, and apartheid was the cornerstone of the state-building project of the South African white ruling elite after World War II.

The *hukou* system in China has a very different history. It was established after the Communist Party came to power in 1949. To ensure that the planned economy met the basic needs of the urban population, a rationing system was instituted in the 1950s, which in turn required the registration of people. As ration coupons could only be used in the locality where they were issued, this automatically restricted the geographical mobility of all people, not just peasants [16]. To reside in a different locality, one needed a special temporary certificate.

This system of passes has been retained to the present day. The constraints this system places on the geographical mobility of migrant workers, and the means

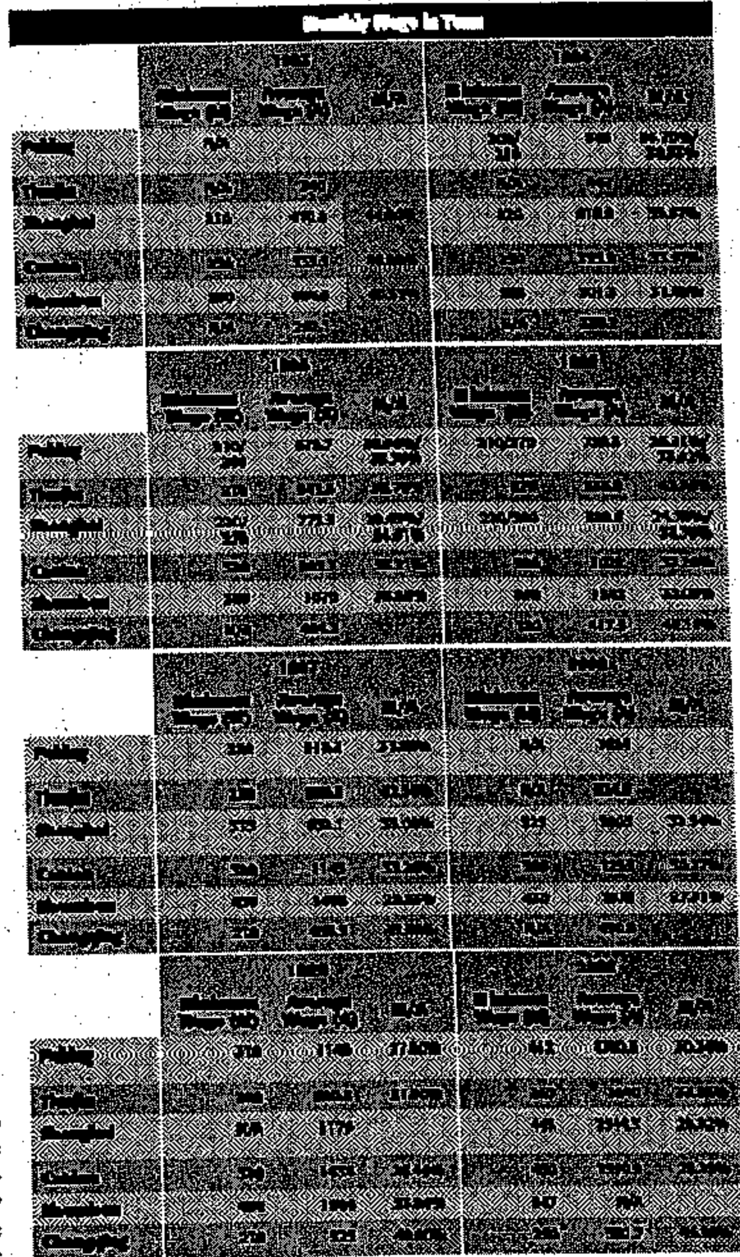
by which this can drive down wages and other labour standards today, is what is similar to what prevailed in South Africa. In China it is there by default. It was in place before it had its present function. It simply continued to be used, when it was found to work well under a greatly changed economic system.

In this transitional period from socialism to capitalism, the temporary work permits required under the *hukou* system act like sluice gates controlling the influx of labour into urban centres. The *hukou* system helps to regulate the flow, letting in more labourers when needed and driving them out when their number exceeds demand, or when the number stretches local facilities to the limit. When workers lose their working ability due to industrial accidents, or when they have become too "old" by the age of about thirty to keep up with the break-neck work intensity, the pass system enables cities to ship them back to the countryside—because without a job a migrant has no right to stay in an urban area. This kind of labour flexibility cannot be as easily imposed on the local urban population.

As more and more state factory workers were laid off in the nineties, some urban governments placed tighter restrictions on job opportunities for the immigrants. One category of jobs after another, especially in the service industries, was reserved only for local residents. In 1993, 40,000 rural migrants in Shanghai were detained and deported; but as the cities clamped down on opportunities, this rose in 1996 to 80,000, and in 1997, 100,000 [17]. There are, however, regional differences in how strictly local governments enforce the *hukou* system. In areas where the supply of labour does not exceed demand by a large margin, the police and local government are considerably more relaxed about the presence of migrants. This is the case in Chengdu in Sichuan province and Fuzhou, Fujian [18].

For local governments, allowing migrants to come in from the countryside can be lucrative. Migrant workers generate local tax revenues by attracting companies that want cheap labour, but because of the *hukou* system the local government has no obligation to pay anything for the welfare of these temporary sojourners. They are not eligible for any of the medical, housing or unemployment benefits available to the local urban populace. Nor are the workers from the countryside allowed by China's pass system to bring their families with

Figure 2 E Proportion of minimum wages to employees average wages in cities of China (1993-2000)



Sources : average wages are from various statistical yearbooks and minimum wages are from various sources, including newspapers and labor bureaus.

them, and thus the urban government has no additional educational expenses to meet either.

Despite this system of permits, the enormous bureaucratic edifice that was erected to control the influx of migrants has not been able to stem the flow, just as had occurred in South Africa. It is impossible to estimate the exact number of Chinese peasants surging out of poor regions in search of jobs, but a range of between 50 to 80 million is often cited. In the week immediately after the Chinese New Year, when migrant workers who have gone home for the festival return to the cities, bringing with them relatives and friends, the effect on transport is dramatic. For instance, in a matter of days Guangzhou, the largest city in South China, suddenly has to handle several million migrant workers descending upon it in trains and buses. In early 2002, before the Chinese New Year, the Guangdong provincial government, in the hope of dampening this vast simultaneous inflow, announced that factories should not recruit new migrants at that time of year; but 5.2 million migrants nonetheless poured in after the New Year, a quarter of a million more than the year before [19].

This large volume of people looking for low-end jobs drives down wages and working conditions and allows these migrants to be exploited by employers, who can pay them the lowest possible wages. New arrivals, in particular, desperate to recoup the amount they have invested in transport expenses and in applying for the array of necessary documents and certificates before leaving home, will take any job available.

Here is the case of one migrant reported in a Chinese newspaper. The young migrant was informed by a friend that if he went to Shenzhen he would find a job. But he was advised that before he left he had to apply for a number of documents. These included a "border region pass" (at 120 yuan, taking six months), a personal identity card (another 80 yuan, taking one month), an unmarried status certificate (60 yuan, valid for one year) and a certificate to prove that he was not born out of quota (45 yuan, valid for one year), all of these totalling 305 yuan [20]. To put this into perspective, the minimum wage in Shenzhen in 2000 was 547 yuan for a full month's work, and this young man would be lucky if he could enter a factory that would pay him as much as that minimum wage.

On arrival in Shenzhen, armed with all these documents, he thought he could become a "legal" migrant worker and could begin working without a problem. But the factory demanded 300 yuan as a deposit before it would give him the job. He then had to spend 40 yuan for a work permit, and another 300 yuan for a temporary residence permit. It short, on arrival at his destination he had to spend another 640 yuan. In all, without including transport costs, he had to spend almost twice as much as the monthly wage. Most new migrants therefore are usually in debt after they first arrive in a city.

According to official statistics, each of the three or four million migrants in the Shenzhen Economic Zone on average spends 600 yuan a year on certificates [21]. Migrant workers have to carry these documents with them at all times or, if caught without them, may be held in detention [22]. To possess all of the necessary certificates, one needs to have proof of a job, and so there is a nervous race to secure one. The deposit that this particular migrant needed to pay to the employer is symptomatic of the desperate situation of most migrant workers. Paying a substantial deposit has become a common practice at the foreign-funded factories. At first sight, the practice seems paradoxical. Instead of the employer paying a worker for the work he or she performs, the worker first has to provide a payment to the employers as surety for the job. The deposit obliges the worker to remain at the factory, or he or she forfeits it. To all intents and purposes the worker is bonded labour [23].

Another practice used by many unscrupulous employers is not to pay a portion of the wages every month, promising to pay the withheld portion at the end of the year. In this situation, the longer a worker has worked, the more money he or she is owed by the employer, and the more difficult it is for the worker to leave. This leaves the worker vulnerable, scared to forfeit all of these unpaid wages when facing poor treatment at the hands of managers.

Finally, and perhaps most effective of all, it is a widespread practice among employers to take away the migrant workers' documents. Without these, under China's system of permits, the workers could not look for another job even when the working conditions in a factory are intolerable and they desperately want to quit.

Workers' dormitories, usually located within the factory compound, extend management control over workers' lives beyond work hours. Movement into and out of the factory compound can be monitored and controlled. Disciplining workers is easier because there is near-total control over them. Especially in the factories in China managed by Taiwanese and Koreans, where the discipline is so strict that the management style can be described as militaristic. In some of the bigger factories that I have visited, workers are even marched to and from meals and to and from dormitories in tight military-style squads [24].

With migrant workers so controlled and cowed, physical abuse has become pervasive in some of the factories owned and managed by Taiwanese, Koreans and Hong Kong Chinese, and acute occupational health and safety problems are also commonplace. A startlingly high incidence of severed limbs and fingers has been recorded.

In Shenzhen city alone, there were over 10,000 certified cases in 1999 among a migrant population of some three to four million [25].

The system of permits needs an enforcement agent—in this case the police. Under the *hukou* system, much as in apartheid-era South Africa, detention by the police if caught without the necessary papers is an inherent part of the system. Their behaviour towards migrant workers has become associated with corruption and abuses of power. Detention is associated not only with fines and deportation from the city, but also with mistreatment, physical violence and forced bribery [26]. With so many migrants pouring in, the arrests are essentially random. In much of Guangdong, people who seem to be of rural origin are simply pulled off the streets and roughed up, sometimes for no particular reason. Among ten young migrants whom I interviewed recently in Shenzhen, five said they have been picked up by the police within the several months they had been there, a few of them more than once; and nine out of the ten knew of a friend or relative who had been detained.

Many migrants do not have all the right papers on them because they are not aware of what they need. Others are too poor to buy them all. But oftentimes, through no fault of their own, their documents are kept locked up by their employer; or they have left a factory without being able to get their documents back because the employer did not want them to leave. As a result of the latter, borrowing documents from friends and purchasing forged ones off the street have become very common [27], as it was in South Africa. According to one survey conducted by a government labour bureau in Guangdong, 80% of foreign employers openly admitted that they did not care whether the documents were fake or not, as this did not affect production [28]. The infringement of regulations being so widespread implies tacit approval has been granted by the local authorities and police.

Yet this does not stop the police from detaining migrants arbitrarily. Police stations consider this a profitable business, because bail, fines and forced bribes, also imposed arbitrarily, can amount to several hundred yuan. Even neighbourhood committees that have no power of detention get into the act. Some have been detaining migrant workers and charging bail [29]. The practice has become so out of hand in the past couple of years that the central government in January 2002 issued a decree reducing the fee for a temporary resident permit to 5 yuan a year nationwide, to enable migrants to afford one and thus avoid detention. And in March 2002 the Guangdong provincial government passed regulations emphasising that the detention of "vagabonds" should be restricted to beggars and not applied to migrant workers who do not have the right papers on them [30]. But rather than obediently comply with the regulations, the provincial police responded by declaring that they have done a good job in sheltering beggars and vagabonds; and reaffirmed the necessity of rigorously implementing the pass system, without mentioning that they were continuing to detain and abuse large numbers of migrant workers [31]. In a few months local-level governments and the police came up with new fees to make up for the loss in revenues and private incomes. Proclamations of new policies do not mean elimination of the *hukou* system. Those who gain from the system are not going to desist so easily.

As can be seen, the Chinese *hukou* system and the pass system under apartheid in South Africa generated quite similar outcomes. They produced a large, vulnerable underclass living in constant insecurity, accompanied by daily discrimination, repression, hardship and denial of their human dignity.

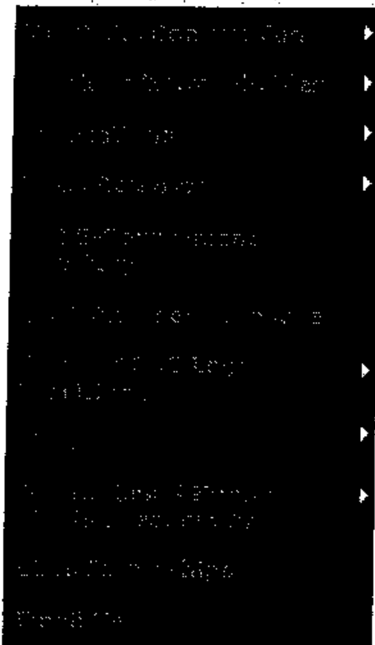
In light of these circumstances, it becomes possible to perceive how the Chinese *hukou* system can keep wages down more easily than in Mexico. As already noted, in Mexico the workers who produce for export are, as in China, largely migrants from the countryside, and the majority similarly are female. But there is a major difference. Almost all of the Chinese female migrant workers are single women in their late teens or early twenties who, because of the household registration system, cannot bring their families with them [32]. Many factories make sure that only single women are recruited by asking to see their officially issued identity certificates, which in keeping with the Chinese state's strict family-planning policy require that the marital and family planning status of each woman is listed. Since the workers are poor single women living in dormitories, management only needs to pay them enough for their individual survival [33].

In Mexico the context is different. While most of the women workers in the *maquiladoras* are migrants from poorer regions, many of them have come with their families, since there is no pass system, and quite a number are single mothers. Very often these women workers are the sole bread-winners. Since they live with their families, a part of their waking hours has to be spent on "unproductive" chores (from management's vantage point): in commuting, in household tasks such as cooking, taking care of the old and the young. No matter how ruthless, there is a limit to the amount of overtime work that management can squeeze out of these Mexican workers—fewer hours than with the young single women in dormitories in China.

There are also legal pressures in Mexico to pay workers a bit more so that they can provide for part of their families' livelihood. The Mexican Labour Law states that "The minimum wage must be sufficient to satisfy the normal necessities of the head of the family in the material, social

Exhibit 13

CONGRESSIONAL - EXECUTIVE COMMISSION ON CHINA



Statement of Mil Niepold
Director of Policy, Verité, Inc.

Before the Congressional-Executive Commission on China
2255 Rayburn House Office Building

April 28, 2003

I would first like to thank the Congressional Executive Commission on China for inviting Verité's testimony today.

Verité's Perspective

"China is an attractive piece of meat coveted by all ... but very tough, and for years no one has been able to bite into it." *Chinese Premier Zhou Enlai, 1973*

Thirty years later, the population is not the only part that has changed - multi-national corporations, global trading organizations like the WTO and even a few IGOs and NGOs have clearly "taken a bite". It is Verité's core belief, and one shared by many advocates, that respect for labor and human rights -- the very same ones that are covered by this Commission's mandate and that China has quite often signed and/or ratified -- comes only when workers themselves are an integral part of the process of enforcing these rights. Later, when I address examples of initiatives that have worked or might potentially work, the direct involvement of workers will be the common thread in each case.

Who is Verité?

Over the past eight years Verité has interviewed approximately 18,000 factory workers for the purpose of identifying the issues workers face in a newly globalized economy. Verité's mission is to ensure that people worldwide work under fair, safe and legal conditions. Our pioneering approach brings together multi-national corporations, trade unions, governments, non-governmental organizations (NGOs) and workers - in over 65 countries - for the purpose of identifying solutions to some of the most intractable labor rights violations.

Verité performs social audits (to date, over 1,000 factory evaluations conducted) to analyze workplace compliance with local and international labor, health, safety and environmental laws and standards. Unique as a non-profit independent monitoring and research organization, Verité, unlike private sector companies, goes beyond monitoring to provide factories with specific recommendations to remedy problems and training for factory management and manufacturers. To address the needs of workers, Verité conducts education programs to teach workers their legal rights and entitlements in the workplace as well as "life skills" (literacy, health education, math, English, and computer skills).

Verité in China

Verité has operated in China - our first and largest area of operation - extensively since 1995. We have conducted nearly 200 factory audits in China over the past eight years, including 112 in the past two years.

Our findings, and those of others, are disturbing:

1. Egregious health and safety violations
    a. China's own Work Safety administration reported 140,000 deaths in '02 (an increase of approximately 30% over '01)
    b. Chinese media sources reported 250,000 injuries and more than 30,000 deaths in industrial accidents in the first quarter of this year alone
    c. The ILO ranks China as the world "leader" in industrial accidents
    d. China estimates 25 million workers are exposed to toxins annually (with tens of thousands incapacitated annually)
    e. The Hong Kong Christian Industrial Committee (HKCIC) reported recently that, after 10 years of research on the toy industry (China produces 70% of the world's toys) that a full 55 - 75% are still classified as poor (80-100 hour workweeks, poor health and safety, not paying minimum wages)
2. Majority of factories use triple or even quadruple books to mask under payment or non-payment of legally mandated overtime premiums (which range from 1.5 to 3 times the base wage depending on the day of the week and whether or not it is a holiday). In some instances it has taken even our most experienced teams **days** of research, interviews and analysis to uncover the true extent of the problem.
3. Limited enforcement of labor laws that are on balance quite robust (for example those requiring overtime premiums, automatic machine shut-off safety devices, compensation for injury,
4. Harassment and lengthy imprisonment for those who report violations, peacefully demonstrate and or who try to associate freely

- Since 1998 Verité has organized an annual China Suppliers Conference that brings together factory owners and managers with governmental officials and non-governmental organization specialists to explore issues and solve problems related to labor compliance in China. *(Last year's conference in Xiamen focused on three aspects of labor compliance: the changing role of unions in Chinese factories; health and safety compliance; and the comprehensive work-hour calculation system and its impact on overtime. Presenters included local government and union officials. This year's conference will provide Verité the opportunity to release a research report on the prevalence of excessive overtime and its impact on worker health and safety).*

  Verité's Worker Education Program, sponsored by Timberland, Eileen Fisher and New Balance, among others, operates in a mobile van which visits southern Chinese factories to provide information on workers' rights, labor law and health information (recently including updates on HIV, Hepatitis and SARS); the Program has reached 18,980 workers since its founding in 2001.

  Verité has facilitated direct communication between factory managers and local labor officials in 40 factories since 2001 by inviting labor officials to accompany auditors to the factories for joint training with factory managers on proper wage-calculation, record-keeping, and employment-contract procedures.

Codes vs. Laws

While not unique to China by any means, there is a growing debate regarding the value of voluntary initiatives (such as Codes of Conduct) versus direct legal obligations within both national and international legal frameworks. For the purposes of this discussion, I will not cover this debate in any detail. However, as we are discussing Codes of Conduct and examples of best practices -- with the aim of achieving improved labor rights compliance in China - I would be remiss if I did not at least touch on this important subject.

Direct obligations - i.e. those placed upon companies through international law - are weaker than those that are indirect (those placed upon them by governments who themselves are fulfilling their obligations under international conventions, etc.). Weaker though they may be, there is nonetheless a clear upward trend in their being extended to corporate (MNC) actors. Movements such as the International Right to Know (IRTK) campaign (*whose recent report includes various case studies, including one on McDonald's and toys made in China*) and the increasing use of US Courtrooms to seek redress for perceived MNC complicity in overseas human and labor rights abuses (for example Unocal, Saipan, and Shell, lawsuits, among others) using the Alien Tort Claims Act (ATCA) are examples of this trend.

So, for our purposes today, you may wonder why these distinctions between voluntary initiatives and direct obligations under international law are relevant? It is simply because, to quote the excellent report by the International Council on Human Rights Policy, we must go "beyond voluntarism". Codes are squarely in the camp of voluntarism and while they are a useful starting point for improving labor rights compliance, they alone are simply not enough to right the "imbalance of power" that exists today between major MNCs and most governments. Governments do not have the resources that MNCs do - resources that are in many places including China - greatly eroded by endemic corruption. Limited resources greatly hinder labor rights enforcement, but they are not the sole issue. I am by no means suggesting that more laws and/or more enforcement are the only answer, but I am saying that rooting both voluntary codes and national laws in a strong international legal framework creates a ripple effect that will help enforcement in ways that merely increasing the number of labor inspectors cannot.

Violations of human and labor rights thrive in cultures of impunity. Take the example of slavery. While now outlawed in virtually every country of the world, this heinous practice continues particularly in countries where the rule of law is eroded. Just as corruption of government officials and police officers allows slavery to flourish - so to do labor rights violations. Strengthening the rule of law in any given country is not a task merely for MNCs and their voluntary initiatives. This is a task for governments. Grounding all efforts in the international legal framework helps to achieve a few important things. It creates a climate that favors compliance by strengthening the effectiveness of voluntary initiatives and national legislation, it strengthens the work of NGO and workers' advocates and it improves judicial efforts, both domestic and international.

Thus, it is incumbent upon those concerned with improving labor rights on the ground in China, as elsewhere, to use multi-layered approaches that draw on past successes. Each approach should also be aligned with the particular "sphere of influence" of the respective stakeholder - thus historically, the greatest successes have come from governments working on the most macro level legislative improvements, government to government consultations, technical assistance programs and the like. MNCs in turn have had success when they assert their considerable leverage primarily at the supplier/factory level but they should continue by all means to exert pressure on governments as well to ensure that the rule of law is both upheld and strengthened. One of the best examples of an MNC working on creative solutions to the most challenging issue in China is the example that you have just heard about from Doug Cahn - the Kong Tai (or KTS) factory election of worker representatives. This initiative is exemplary and there are others:

- The Institute of Contemporary Observation recently launched an initiative that provides

posters in factories that outline workers' rights under Chinese law and they provide a hotline for workers to call if they are the victims of violations

- A coalition of over 20 NGOs and SRIs (Socially Responsible Investors), including the International Labor Rights Fund, Global Exchange and Amnesty International USA started the US Business Principles for the Human Rights of Workers in China. To date nine MNCs are participating in this China Working Group (3Com, Cisco, Intel, KLA-Tencor, Nike, Palm Computing, Reebok and Target) working to implement the Principles or similar Codes of Conduct.

It is very common to discuss the "sticks" when discussing human and labor rights. But, I find the "carrots" to be of greater interest. The examples cited above share a few things - most notably the inclusion of the workers in the process - but most of all they are implicitly or explicitly capitalizing on the fact that there is competitive advantage to be gained from transparency, disclosure and good working conditions. If the industrial revolutions in the US and the UK have shown us anything they have shown us that good factories make better products and over the longer term, that are more cost-effective.

Conclusion

" *Apart from their other characteristics, the outstanding thing about China's 600 million people is that they are "poor and blank." This may seem a bad thing, but in reality it is a good thing. Poverty gives rise to the desire for change, the desire for action and the desire for revolution*. On a blank sheet of paper free from any mark, the freshest and most beautiful pictures can be painted." *Mao Zedong 1967*

The picture for labor rights in China would have to include the following:

- Harmonization of the multiple codes of conduct (factory owners rightly complain that the profusion of codes is a confusing time-sink and with at times 40 audits a month by inexperienced CPAs, auditing as it is conducted by private sector firms is harmful to workers and disruptive to production cycles)
- A greater degree of responsibility on the part of MNCs who wreak havoc on factories through pressures to lower prices paid to factories and "just in time" delivery demands that inevitably lead to excessive, often forced, overtime
- Passage, or modification, of embodying legislation required under China's ratification (2001) of the ICESCR (International Covenant on Economic, Social and Cultural Rights and their membership in the ILO (specifically with regard to freedom of association and collective bargaining) and withdrawal of their reservations
- A direct contact mission from the ILO

This would be a beautiful picture indeed. Thank you.

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Exhibit 14

CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

ANNUAL REPORT

2002

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

OCTOBER 2, 2002

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nies frequently require excessive overtime that is not paid properly.[70]

Migrant workers living in dormitories connected with factories in southern China often face conditions of severe overcrowding, lack of proper sanitation facilities, and inadequate fire and safety protection. Many have been denied medical care, access to schools for their children, and other social benefits.

As in many areas covered by this report, the wide discretion that local and provincial officials often have in interpreting and implementing national laws and regulations results in inconsistencies in application and opens the door to corruption. For example, China's Labor Law allows enterprises, with the approval of the local "labor administrative department," to adopt their own rules for working hours[71]—an obvious invitation to abuse.

Labor Arbitration and Litigation

The Labor Law and the Regulations for the Handling of Labor Disputes create a three-tier system for handling labor disputes that includes mediation, arbitration, and litigation.[72] With the help of legal aid and information centers, some Chinese workers have begun to understand their legal rights. In 2001, workers filed 155,000 labor disputes, a 14 percent increase over 2000, although statistics on the issues underlying these disputes are not available.[73]

Nevertheless, general awareness of China's laws and regulations on the part of workers, management, and even some government officials remains low.[74] The Hong Kong Christian Industrial Committee, a group that organizes and provides assistance to workers in Hong Kong and China, found that among the workers they interviewed, "Less than half . . . said they knew about labor law. None of the workers knew about other regulations concerning labor rights. Workers had no idea how to use the laws to defend their rights."[75] Programs for enforcement generally do not exist, and enterprise managers often ignore the regulations even when they are aware of them.[76]

Worker advocates often find themselves in peril. Xu Jian, a labor lawyer in the northern China city of Baotou, who represented laid-off workers seeking redress from two large state-owned enterprises, published pamphlets for workers describing their rights under Chinese law. He was arrested and sentenced in 2000 to four years in prison for "incitement to overthrow state power."[77] Local authorities in Shenzhen reportedly have ordered Zhou Litai, a lawyer who successfully represented migrant workers injured in the workplace, to close his law practice in that city.[78]

Ultimately, judgments about the success of labor arbitration and litigation can rest only on whether workers receive fair and impartial adjudication of disputes, whether these remedies are made available to laid off workers (not currently entitled to this right under the law),[79] and to what extent labor advocates are allowed to assist workers to pursue grievances and assert their legal rights.

Child Labor

China ratified ILO Convention 182 on the Worst Forms of Child Labor in August 2002.[80] China's Law on the Protection of Minors

Exhibit 15

Policy Brief
OECD

September 2003

Attracting Investment to China

What has foreign investment done for China?

How to attract high-quality FDI?

Will a rules-based investment environment help domestic enterprises?

How can FDI policy serve China's regional development aims?

How to make things simpler for investors?

Is the financial sector open enough?

How to make the system more transparent?

How to improve the legal system?

For more information

For further reading

Where to contact us?

Introduction

Foreign investment has played an important role in China's economic development for almost a quarter of a century and is vital for that development to continue. But while China has been highly successful in attracting foreign direct investment (FDI) so far, and has made significant progress in improving its FDI policy framework, it has not fully exploited its potential to attract investment from OECD countries.

To make the most of the potential benefits of joining the World Trade Organization (WTO) and to increase FDI inflows while enhancing their contribution to domestic development China will need to persevere with efforts to bring its laws and regulations into harmony with internationally recognised standards and to ensure they are fully and consistently implemented at local level.

A new *OECD Investment Policy Review, China: Progress and Reform Challenges*, looks at progress to date in China in attracting foreign investment and in moving towards a more rules-based business environment. It suggests policy choices designed to increase the amount of foreign investment from advanced countries. ■

OECD Observer

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What has foreign investment done for China?

China has made significant progress in providing a business environment conducive to FDI since the major shift to economic reform in 1978. A closed economic system has been rapidly opened to trade and investment. Major economic institutions have been replaced or transformed. Others, like the state-owned enterprises and the financial system, are undergoing lengthy reform that will bear fruit in the future.

FDI has played an important role in this transformation. It has enabled China to establish new branches of industry and Chinese consumers to experience a far wider range of goods and services. It has brought in new technology in many fields. Foreign-invested enterprises have provided employment, directly or indirectly, to millions of people, as well as training and experience in both technological and managerial skills which can be transferred to domestic enterprises. FDI has played a major role in expanding China's international trade, which is now equivalent to half of the country's gross domestic product (GDP), with foreign-invested enterprises accounting for half of all two-way merchandise trade.

Even so, China receives far less FDI per head than many other developing as well as developed countries. For example, in 2000 China received USD 30 per capita while Brazil received USD 195 and OECD member countries an average of USD 1,321 (see table below). Much FDI in China still goes to short-term, labour-intensive manufacturing, while investment in high-tech activities, particularly in services sectors, lags behind. There is therefore still much scope for raising the quality of FDI as well as continuing to increase its quantity. ■

How to attract high-quality FDI?

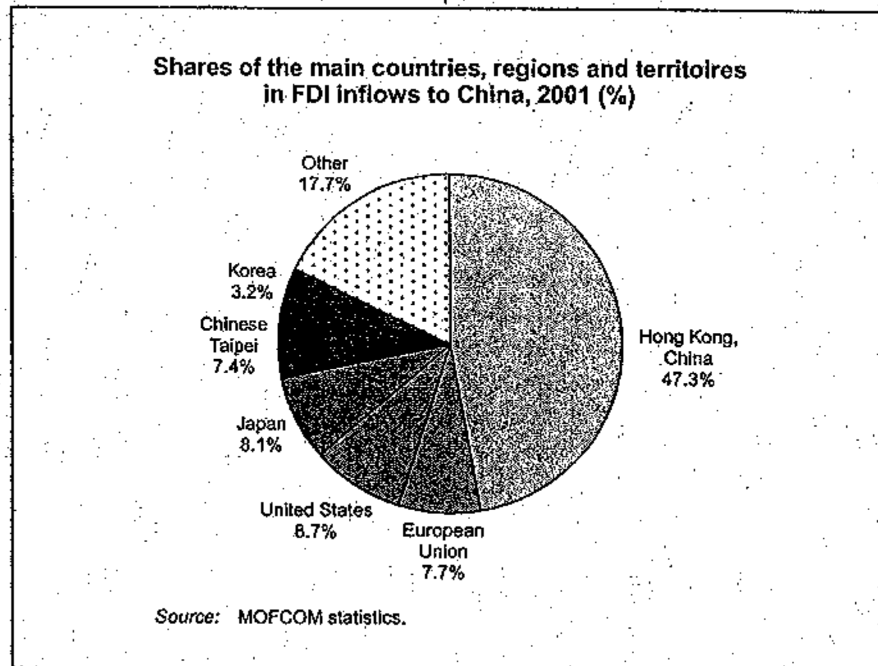
The challenge for China now is to improve further its policy framework in order to attract more long-term, capital-intensive, high-tech projects in more sectors of the economy and hence to reap the maximum benefit from spillovers of skills and expertise from the foreign corporate presence.

China's accession to the WTO has already brought about major advances in FDI policy. In addition to the removal of trade-related investment measures, China is also opening up its services sectors, including the financial sector. Existing foreign-invested enterprises are now able to distribute their products in China and engage more widely in for-

FDI inflows per capita to China and selected countries and territories, 2000 (US$)

Country or territory	FDI per capita
China	30.1
OECD average	1,320.9
India	2.2
Indonesia	-21.6
Malaysia	162.8
Myanmar	5.3
Philippines	16.3
Singapore	1 547.2
Thailand	54.0
Vietnam	16.7
South Africa	22.2
Argentina	314.8
Brazil	195.4
Chile	241.6

Source: *Calculated from* IMF, *International Financial Statistics, October* 2002.



Source: MOFCOM statistics.

eign trade. These changes will provide opportunities for enterprises based in OECD member countries to play a bigger role in making direct investments in China.

Multinational enterprises in OECD countries have the capital and the technology to provide longer-term projects embodying advanced production methods. However, OECD members have so far provided a disproportionately small amount of FDI to China, at least partly because of perceived weaknesses in the legal and regulatory framework for investment.

In the early period of reform and opening up of the economy, China's offer of incentives such as lower taxes was effective in attracting foreign investors. But now China is well on the global investment map, it is not clear that such a rich set of incentives is necessary for attracting FDI. Indeed, recent surveys show that foreign investors are much more concerned about the overall regulatory regime than about incentives, and that they prefer to locate investments, especially large, long-term ones, in countries with predictable policy regimes.

Beyond offering fiscal incentives, the Chinese government has in fact worked hard to make investment easier by measures such as reducing delays in approving FDI projects and improving the physical infrastructure. A rules-based investment environment is also now gradually beginning to take shape, though there is still much to be done.

China is striving to develop an impartial and effective court system, but, for institutional and manpower reasons, this work will take years, rather than months. Effective implementation of law matters because investors, whether foreign or domestic, need to have guaranteed property rights, including intellectual property rights (IPR). Much stronger implementation of China's IPR protection legislation and its international commitments in this regard is needed, not just to attract FDI but also to stimulate domestic creativity. As the history of world technology shows, Chinese people are themselves highly inventive when the institutional framework allows them to be so. The sharply rising number of domestic patents is testimony that this is still true.

Investor confidence also relies on a legislative and regulatory regime that is stable, internally consistent and publicly available in an understandable form. Coherence between national and local legislation and regulation is encouraged by WTO, OECD and other internationally recognised standards. The existence of undisclosed internal rules for approval

also organise visits by officials from the Western and Central regions to their counterparts in SEZs and other open zones in the Eastern Region to share experience and gain a deeper understanding of procedures that have been successful in attracting investment. Such measures would be relatively cost-effective and remain useful even if the "invest in the West" policy were to be modified. ■

How to make things simpler for investors?

Proposed foreign investment projects are divided into a fourfold classification categories: encouraged, restricted, permitted and prohibited categories. The so-called "catalogue" of 'permitted' investment projects – far longer in practice than the other three – is not in fact a published list, but consists of all projects not listed in the other three categories, which are published as separate catalogues.

Following WTO accession, China reduced the number of prohibited and restricted project types and increased the number that are permitted and encouraged. The Chinese authorities are to be commended for this step and encouraged in their efforts to achieve further liberalisation of the catalogue regime.

More categories of project could be removed from the list of prohibited foreign investment industries. The inclusion of sectors where national control is considered desirable, such as projects that endanger the safety and performance of military facilities, is understandable; where not self-evident, an explanation of the reasoning involved would be helpful. For instance, China currently prohibits FDI in a few traditional crafts such as the production of green tea, traditional Chinese medicines, bodiless lacquer ware, rice paper and ink tablets. The intention of this prohibition is presumably to ensure the continued existence of these activities because they are considered to be part of the national heritage. If this is the case, the prohibition of inward financial flows supporting such activities would appear to be an inappropriate means of achieving such an aim, which might more effectively be pursued by other measures, for example by increasing the resources available for education and training in these fields. Another category of prohibited FDI is the establishment of futures companies. There appears to be no advantage to be gained from banning FDI from entering this financial sector that could not be more effectively obtained by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises.

It is therefore not immediately clear that there is any benefit in maintaining an extensive "restricted" list, effectively raising the approval hurdle higher for a wide range of industries and services, including, it is important to note, most of the services sectors being opened as a result of WTO accession. The Chinese government could consider abolishing this category entirely when it considers further opening to foreign investment to be appropriate.

Unlike the other two published categories, the "encouraged" category does not restrict FDI in any way. The future of this category will largely be determined by the Chinese government's policy regarding FDI-attracting incentives. One reason for questioning the need for its continued existence is the increasing length and complexity that have resulted from successive liberalisations. The list is now so detailed that many of the items are likely to become rapidly obsolete as a result of technological progress.

A clearer presentation of the permitted range of foreign investment activities could be achieved by replacing the catalogue regime with a single short list of sectors that are barred to foreign participation, supplemented by a clear explanation of the grounds for selection. All projects not on the list would then be permitted.

One problem that appears to persist is that internal regulations (neibu) governing the process by which FDI projects are approved still exist alongside public regulations (gongkai). The internal local regulations, which are not published, are said to be generally more restrictive than national legislation and regulations but unless they are made public it is not possible to judge whether or not they are acceptable. The Chinese government is committed to solving this problem. A rational solution would involve a two-step procedure. First, local

Exhibit 16

CHINA COUNTRY COMMERCIAL GUIDE FY 2004

A Guide to Doing Business in China &
Information on Current Economic Conditions

Prepared by: The U.S. Embassy, Beijing
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materials, and manufacturing equipment. Total industrial value-added rose 12.6 percent in 2002 and maintained strong growth into the first half of 2003. The full "secondary sector" of GDP, which includes construction as well as industry, grew 9.9 percent in 2002, to make up over half of total gross domestic product. In contrast, China's entire services sector produced slightly less than 34 percent of GDP and increased 7.3 percent in 2002, while agriculture, which continues to employ half of China's 740 million strong labor force, only contributed 14.5 percent and grew a meager 2.9 percent year-on-year.

Retail sales of consumer goods were slightly under RMB 4.1 trillion in 2002, an increase of 8.8 percent over the 2001 total. Nevertheless, this rate of increase represents a slowdown of over a percentage point from the growth rate recorded a year early. In addition, the SARS outbreak had a dramatic impact on retail sales growth in the first half of 2003. Retail sales of consumer items only increased 4.3 percent in May 2003, the lowest rate of growth recorded in over a decade.

C. Government Role in the Economy

Although 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. In addition, 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 state-owned enterprises 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.

Although direct price controls on most commodities have been eliminated, prices for thirteen broad categories of items, including electric power, transportation, telecommunications, and some services, remain subject to varying degrees of government "guidance." Petroleum prices have generally been allowed to fluctuate in accord with the international market. The government sets all interest 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.

D. Infrastructure Investment

Infrastructure investment is a key element of China's economic growth potential, with major infusions scheduled for the road, railway, port, telecommunications, oil and gas, and coal sectors. Improvements to the rural electrical grid are also underway. Since 1998, the Chinese Government has issued about RMB 790 billion in special bonds to fund infrastructure projects aimed at stimulating the domestic economy. This has kept growth in overall investment in double-digits. Total fixed asset investment grew 16.1 percent in 2002. Infrastructure investment, which rose 16.4 percent in 2002, accounted for about 40 percent of the total. State planners have set a target for total increase in fixed asset investment of 12 percent for 2003. Through May 2003, however, fixed asset investment by state-owned and "other" entities (the latter being mostly mixed public-

private and foreign invested enterprises) increased nearly 32 percent year-on-year, with infrastructure investment growing 28.7 percent.

Although the government is no longer explicitly pursuing a tight credit policy to quell inflation, its efforts to improve the asset quality of the state-owned banking system effectively limits the kinds of projects which receive official approval and which the banks will finance. Private firms, in particular, still have serious difficulties in raising capital. State-sponsored infrastructure projects are seen as "safe" investments for domestic financial organs. Financing for key projects comes from an increasing variety of sources, including special construction funds, surcharges on power and other utilities, provincial and local government budgets, as well as domestic loans from the China Development Bank and other banks.

Chinese officials have said they would prefer roughly 15-20 percent of infrastructure investment to come from foreign sources, but shifting foreign investment away from export-oriented industries presents some difficulties. Infrastructure investments have long payback periods, with no ready source of foreign exchange. Policies designed to attract foreign investment, notably those inspired by the central government's "Great Western Development Strategy," have tended to emphasize land-use and tax incentives without addressing more fundamental problems in the investment environment. China's weak legal structure, failure to enforce contracts and court decisions, restricted access to foreign exchange, and the cumbersome approval process work against foreign participation in infrastructure projects, particularly in the road, rail and power sectors. The regulatory impediments to foreign involvement in infrastructure projects are gradually disappearing. For example, changes in rules governing current account transactions have gone a long way toward solving the problem of guaranteeing foreign exchange convertibility.

Infrastructure development in the telecommunications sector remains strong and China now boasts the largest wireline and wireless networks in the world. The Chinese Government's policies have contributed to this growth. They have made telecom and IT development a national priority and enacted preferential policy initiatives to promote telecommunications modernization throughout the country. In addition, technological advances have contributed to network expansion by making better equipment available at lower prices. In 2002, telecommunications fixed asset investment decreased sharply by over 20 percent due to fierce competition and restructuring in the industry, but showed some recovery in 2003 with significant spending on network expansion by the telecom providers. In the first five months of 2003, this investment totaled RMB 57.2 billion, an increase of 41.9 percent compared with the same time period from 2002.

3. Political Environment

Although there has been considerable reform of China's economic model - from a centrally planned economy to a market-oriented one - the same is far less true of the PRC's (People's Republic of China) political system. The Chinese Communist Party (CCP) still dominates the entire political apparatus, and its leaders make all major policy decisions. Party members hold most senior government positions at all levels of administration. Ultimate authority rests with the 24 members of the CCP Politburo and, in particular, its nine-member Standing Committee. Ministries and lower-level counterparts implement policy on a day-to-day basis, and China's parliament, the

Customs officers check the price reported by the importer against this database. Normally, Customs officers will accept the importer's price. However, if the reported value is too far out of line with the database, the Customs officer will estimate the value of the goods based on methods listed in Article 7 of the PRC Measures for the Determination of Customs Values for Imported and Exported Goods.

Tariff classification. China Customs only uses an eight-digit harmonized tariff system, as opposed to the more detailed ten-digit codes. Customs officers have wide discretion to classify in what general category to place each import.

Taxes: On top of normal tariff duties, both foreign and domestic enterprises are required to pay value-added taxes (VAT) and business taxes. VAT is assessed on sales and importation of goods and provision of processing, repairs and replacement services. Business taxes are assessed on providers of services, the transfer of intangible assets and/or the sales of immovable properties within China. VAT is assessed after the tariff, and incorporates the value of the tariff. China is now bound by WTO rules to offer identical tax treatment for domestic and imported products. VAT is collected regularly on imports at the border, although importers note that their domestic competitors often fail to pay taxes.

China offers a variety of tax incentives and concessions. The general VAT rate is 17 percent but necessities, such as agricultural products, fuel and utility items, are taxed at 13 percent. Enterprises regarded as small businesses (those engaged principally in production of taxable goods or services with annual taxable sales of less than RMB 1 million or those engaged in wholesaling or retailing of goods with annual sales of less than RMB 1.8 million) are subject to VAT at the rate of 4 percent or 6 percent, depending on the nature of the business. Unlike other VAT payers, small businesses are not entitled to claim input tax credits for VAT paid on their purchases. Certain limited categories of goods are exempt from VAT. Likewise, many foreign-invested processing enterprises are exempt from taxes if they export their products.

VAT rebates up to 17 percent (a full rebate) are available for processed exports. Exporters complain that it takes months to obtain the rebates and amounts are often miscalculated. Also, rebates are limited by the local budgets, and coastal provincial authorities often run out of funds for rebates well before the end of the year. The applicable rebate method varies and is a function of the establishment date of the enterprise.

China intends to eventually phase out its two-tier income tax system for domestic and foreign enterprises. Domestic enterprises have long resented rebates and other tax benefits enjoyed by foreign-invested firms. The move towards national treatment will mean the gradual elimination of special tax breaks enjoyed by many foreign investors. However, in some cases Chinese authorities have promised to grandfather existing foreign investments with current tax incentive deals for at least a certain period of time.

B. Trade Barriers

The Chinese Government has recognized for years that economic reform and market opening are essential components of sustainable and balanced economic growth. The Chinese Government in 2001 and 2002 undertook a massive effort to revise its laws and regulations in a manner consistent with WTO rules. At the Central Government level,

China has already revised or repealed hundreds of laws and regulations to ensure WTO consistency. However, while China has an increasingly open and competitive economy, substantial barriers have yet to be dismantled. Import barriers, an opaque and inconsistent legal system, and limitations on market access combine to make it difficult for foreign firms to operate in China. Business interests must be realistic about the impact of WTO accession. It will bring enormous changes – both economically and socially – but WTO entry will not remove all commercial problems and the implementation process will take time.

Some of the current trade barriers that U.S. firms face are:

Tariffs: WTO accession will have a dramatic effect on tariffs for many products of interest to the United States. China must reduce tariffs for U.S. priority agricultural products from an average of 31 percent to 14 percent by January 2004. Tariffs for some passenger cars were over 100 percent prior to accession, and must be reduced to 25 percent by 2005. The Information Technology Agreement calls on China to eliminate duties on IT goods – such as semiconductors and computer hardware –by January 1, 2005. Still, China plans to maintain high duties on products that compete with those of domestic industries the Chinese Government seeks to protect. For example, the tariff on large motorcycles will only fall from 60 percent to 45 percent. Likewise, most video, digital video, and audio recorders and players will still face duties around 30 percent.

Import Quotas: WTO rules bar quotas and other quantitative restrictions. China has been gradually eliminating them and will continue this process after accession over a multi-year phase-in period. The bilateral agreement with the United States required China to eliminate existing quotas for the top U.S. priority products upon accession and phase out remaining quotas, generally by two years but no later than five years after accession. After two rounds of quota elimination, quotas limit eight categories of imports, including automobiles, motorcycles, oil, rubber, and tires. Bureaucratic delays in allocating quotas have disrupted imports of many products such as passenger cars.

Tariff-Rate Quotas (TRQs): China applies TRQs to imports of wheat, corn, rice, soy oil, cotton, barley, vegetable oils, and fertilizer. With its WTO accession, China for the first time published TRQ levels and the regulations governing TRQ administration. China will gradually increase these already-large TRQ levels. A growing portion of each TRQ will be reserved for importation through firms other than state trading entities. To ensure full use of the TRQs, China agreed to specific rules for administration of the TRQs, including increased transparency and reallocation to importers of any unused quota. In China's first year as a WTO member, TRQ allocation, like quota allocation, was plagued by official delays. Timing of TRQ allocations and re-allocations seemed to improve in 2003, but concerns remained over China's system of TRQ administration. The National Development and Reform Commission (NDRC) refuses to publish the names of or answer inquiries about agricultural quota recipients. The NDRC also reserves a portion of TRQs - over 60 percent for some commodities - for the processing trade, requiring quota recipients to process and re-export the products they import or face stiff penalties. In addition, licensing requirements for TRQ recipients are burdensome and many firms have been given quota allocations far below commercially viable levels.

Import Licensing: Products subject to import quotas or TRQs also require import licenses, including some wool, grains, oilseeds and oilseed products, cotton, iron and steel products, commercial aircraft, passenger vehicles, fertilizer, hauling trucks, and

rubber products. China has also added license requirements to some products in an effort to combat smuggling; for example, China requires licenses for meat traders. The Ministry of Commerce (MOFCOM) administers the licensing system, but has given primary authority for approval and import of some agricultural items to the General Administration of the PRC for Quality Supervision, Inspection, and Quarantine (AQSIQ). Import licenses are not always easy to obtain, and importers frequently report long delays.

Export Licenses: Fifty-two categories of Chinese exports require licenses. Garment and textile exports – which are strictly limited by importing countries and require quota visas to enter foreign markets such as the United States – make up the bulk of these exports. Beyond textiles, products requiring licenses include some raw materials and metals, lethal chemicals, and food products. China also requires export licenses on products that are the subject of countervailing duties in a foreign market. MOFCOM is responsible for the enactment of general policy on export licenses, but local-level Economic and Trade Commissions are beginning to take charge of issuing specific export licenses. Currently, many quasi-governmental chambers of commerce, such as the China Chamber of Commerce for Import and Export of Machinery and Electronic Products (CCCME) and the China Chamber of Commerce of Metals, Minerals & Chemicals Importers and Exporters (CCCMC) have been tasked by the Government to coordinate applications for licenses. The licenses are issued by local Economic and Trade Commissions, which report to MOFCOM.

Transparency: China publishes laws and regulations relating to international trade in the China Foreign Trade and Economic Cooperation Gazette, published by MOFCOM and available by subscription. Most government ministries also publish the texts of related laws and regulations on their websites. Economic newspapers routinely carry the texts of government circulars, announcements and regulations. In addition, there has been a proliferation of online news and information services such as chinaonline.com, sinolaw.com, and sohu.com that offer up-to-date news about and texts of new laws and regulations. As a WTO member, China has committed to publishing for comment all measures that could affect trade in goods, services, TRIPS or the control of foreign exchange, and to providing a translated copy of new laws, regulations, and other measures to the WTO Secretariat in Geneva no later than 90 days after promulgation. MOFCOM has established an "Enquiry Center" to provide information on commercial, investment, and trade laws and regulations. Despite this progress, transparency remains a problem for foreign companies. Many new regulations and rules have been promulgated without adequate comment periods. Chinese ministries often implement policies based on internal "guidance" or "opinions" that are not available to foreign firms. Experimental or informal policies and draft regulations are regarded as internal matters and public access is tightly controlled. Drafts are sometimes given to domestic companies but not foreign-invested enterprises for comment. The rule-making process remains secretive and opaque. Furthermore, because laws and regulations are often very general, many decisions are left to the discretion of the implementing bureaucrats, who can make decisions without resorting to public comment or open procedures.

Legal Framework: Laws and regulations in China tend to be far more general than in most OECD countries, thus usually requiring more specific implementing rules and measures. This vagueness allows Chinese courts and officials to apply them flexibly, which results in inconsistencies. Companies sometimes have difficulty determining precisely whether or not their activities contravene a particular regulation. Agencies at

Hong Kong, although the limitations on convertibility of the Chinese currency will impede Shanghai's ability to supplant Hong Kong. (See separate report on Hong Kong's investment climate.)

A growing number of firms are opting to channel their China investments through vehicles registered in the freeports of British Virgin Islands, the Cayman Islands, and Western Samoa. In 2002, new FDI nominally from these three tax haven economies accounted for 15.5 percent of total new FDI. The ultimate origin of this FDI is unclear, but anecdotal information suggests that it includes investments from corporations headquartered in OECD economies, Taiwan, and even China itself. The rise in investment from these freeports correlates closely with the decline in investments from Hong Kong, suggesting that some firms are shifting the nominal origin of their investments.

Types of Foreign Enterprises in China: Among the three main foreign investment vehicles available to foreign investors, WFOEs are currently the most popular. New registration of WFOEs exceeded that of JVs for the first time in 2000. WFOEs accounted for 65 percent of projects approved in 2002. By value, WFOEs represented 69 percent of these deals, a dramatic increase from previous years, as wholly-owned ventures became possible in a greater range of industrial sectors. JVs with Chinese firms are still required, however, in many industries of interest to U.S. investors.

Encouraged versus Restricted Investment: China attempts to guide new foreign investment towards "encouraged" industries and regions. Over the past five years, China has implemented new policies introducing new incentives for investments in high-tech industries and in the central and western parts of the country in order to stimulate development in less developed areas. A new catalogue took effect April 1, 2002, replacing the December 1997 list and designating sectors in which foreign investment would be encouraged, restricted or prohibited. Unlisted sectors are considered to be permitted.

Among other things, the new catalogue aims to implement sectoral openings that China promised in its WTO accession agreement, including banking, insurance, petroleum extraction, and distribution. According to an accompanying regulation, projects in "encouraged" sectors benefit from duty-free import of capital equipment and value-added tax rebates on inputs. The same regulation states that approval authority for "restricted" investments rests with the relevant central government ministry and may not be delegated to the local level. For a number of restricted industries, a Chinese controlling or majority stake is required. Industries in which foreign investment is prohibited include national defense, firearms manufacturing, most media content sectors, and biotechnology seed production.

Regulations governing foreign investment in specific industries have been issued in large numbers over the past few years, spurred by WTO obligations to open these sectors. Prospective investors should examine these regulations carefully.

Mergers and Acquisitions (M&A): China recently issued new regulations governing foreign purchase of stakes in domestic enterprises. Regulations issued in November 2002 permit foreign purchase of traded and non-traded (designated state) shares of Chinese enterprises. In addition, China issued regulations that took effect in April 2003, specified procedures for foreign acquisition of and merger with domestic enterprises.

partner as part of its capital contribution. China has committed to enforce only those laws or other provisions relating to the transfer of technology or other know-how if they are in accordance with WTO provisions on protection of IPR and TRIMS, including a prohibition on technology transfer as a condition to approval. Regulations promulgated in 2001 have generally improved the regulatory environment for foreign technology providers. Despite these commitments, foreign investors may still encounter pressure to transfer technology.

Employment of Host-Country Nationals: Rules for hiring Chinese nationals depend on the type of establishment. Although FIEs are not required to nominate Chinese nationals to their upper management, in practice, expatriate personnel normally occupy only a small number of managerial and technical slots. In some ventures, there are no foreign personnel at all.

The amended EJV Law provides that the joint venture partners will determine, by consultation, the Chairman and Vice-Chairman. If the foreign side assumes the chairmanship, the Chinese party must have the vice-chairmanship, and vice-versa.

While FIEs are free to recruit employees directly or through agencies, representative offices of foreign companies must hire all local employees under contract with approved "labor services companies." These foreign companies pay the contracted local employees' salary directly to the "labor services companies" that, in turn, give only a portion of the salary to the contracted employees. The employees remain technically employed by the labor services company.

F. Right to Private Ownership and Establishment

In the past, China restricted private ownership and establishment of business enterprises, particularly in the service sector. In 1999, China amended its constitution to provide a legal basis for private sector development. Upon accession to the WTO, China committed to reduce over time many restrictions on the private sector. Nevertheless, some sectors -- insurance, for example – will retain many restrictions, and some of these discriminate against foreign legal and natural persons.

G. Protection of Property Rights

Land: Chinese law provides that all land is owned by "the public," and individuals cannot own land. However, consistent with the policies of reform and opening to the outside, legal and natural persons, including foreigners, can hold long-term leases for land use. They can also own buildings, apartments, and other structures on land, as well as own personal property.

Intellectual Property Rights: Overview

Chinese leaders have acknowledged that protection of patents, copyrights, trademarks, and specialized intellectual property such as domain names and plant variety rights is needed to promote a "knowledge-based economy" in China. China committed to full compliance with the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS) upon accession to the WTO. China's legal framework is increasingly compliant with the TRIPS Agreement and international standards, although in some key areas such as implementing enforcement procedures and legal remedies that have a deterrent

submit to the relevant government agencies is compromised, leading unscrupulous local generic producers to produce unauthorized imitations, sometimes with poor quality or content standards, resulting in unhealthful products.

While industries report improved cooperation with administrative enforcement agencies in regard to raids, the administrative penalties for IPR violations, often no more than confiscation of the counterfeit products or nominal fines, are generally insufficient to deter counterfeiters. Very few cases are referred to criminal prosecution because the threshold for initiating criminal cases for IPR infringements remain very high. China's criminal sanctions against IPR violations are seldom used, in part because of restrictions on types of admissible evidence and unclear mandates for law enforcement authorities with little experience in prosecuting IPR violations.

Combating IPR violations in China is a long-term, multifaceted undertaking. China has established special IPR courts in all provinces and major cities. Judges in Chinese courts are charged with fact-finding and have greater discretion in the adjudication of cases than those in the United States. However, the lack of legal training of many trial court judges undermines the effectiveness of these courts. The U.S. Government and U.S. companies have provided resources for training judges and other enforcement officials. Chinese authorities are attempting to address the lack of training of enforcement officials by establishing IPR law centers at Beijing University, Qinqhua University, and People's University. Chinese IPR professionals are also studying in foreign countries. The United States and the European Union have made IPR -- and commercial dispute resolution -- a key feature of "Rule of Law" discussions with Chinese authorities.

H. Transparency of the Regulatory System

China's legal and regulatory system lacks transparency and consistent enforcement despite the promulgation of thousands of regulations, opinions, and notices affecting foreign investment. Although the Chinese Government has simplified the legal and regulatory environment for foreign investors in recent years, China's laws and regulations are still often ambiguous. Foreign investors continue to rank the inconsistent and arbitrary enforcement of regulations and the lack of transparency as two major problems in China's investment climate. No prospective foreign investor should venture into the China market without due diligence and professional advice.

In accordance with China's WTO commitments, the State Council's Legislative Affairs Office has stated that all of China's foreign trade-related and foreign-investment related laws, regulations, rules, and policy measures will be published. It further announced that China would use "proper ways and means" to help other WTO members and other pertinent individuals and enterprises understand those rules and regulations. The Legislative Affairs Office acknowledged that, in the past, some departments and localities relied on their own internal documents to conduct business. Some even issued documents under their own "internal control" and resorted to "disguised forms of market blockades" and local protectionism. The State Council has announced that it is committed to stopping such practices in order to avoid international disputes.

Chinese Government agencies have also begun to publish some trade-related regulations in draft for public comment, including comments from foreign parties. This process, required by China's WTO accession agreement, is still in its early stages.

Comment periods are sometimes extremely brief, and it is not always clear how much impact public comments have on the final regulations. Indeed, many regulations are published in final form, making any comments made by interested parties ineffective in altering their contents. Moreover, China still lacks a single source, along the lines of the U.S. Federal Register, for public releases of draft documents. Some government agencies have released draft regulations in advance only to certain favored enterprises (usually domestic enterprises) or have allowed enterprises only to read but not retain drafts. Also, comments by interested parties do not become part of a public record.

The official website www.fdi.gov.cn contains many investment-related laws and regulations in both the original Chinese and English translation as well as research reports and statistics on inward FDI.

I. Capital Markets and Portfolio Investment

The development of China's domestic capital markets has not kept pace with economic needs. Two stock exchanges have been established in Shanghai (in November 1990) and in Shenzhen in southern China's booming Guangdong Province (July 1991). Other regional "securities exchange centers" have been closed by the China Securities Regulatory Commission (CSRC). The Securities Law took effect in June 1999. The Law includes tougher penalties for insider trading, falsifying prospectuses and financial reports, and other forms of fraud. The CSRC lacks experienced personnel and has turned to the United Kingdom and other countries for more training. China's stock markets are gradually adopting accounting standards closer to those in use in other markets.

Although FIEs, in theory, may apply for permission to raise capital directly on China's stock and bond markets, the approval process is difficult. In the case of shares, the CSRC has indicated that it plans to treat FIEs the same as domestic firms.

The state banking sector dominates China's capital markets and in the past, generally channeled funds to SOEs on the basis of Communist Party policy rather than market considerations. Other domestic firms must find different sources of financing, including direct investment, gray-market sales of stock, and borrowing from other firms or non-bank institutions.

China's progress in reducing political interference in the banking system has been mixed. The authorities have encouraged China's commercial banks, all of which are wholly or partially state-owned, to improve their loan portfolios by increasing the proportion of their lending to small and medium-sized enterprises, including private firms. Lending to individuals for housing mortgages, purchase of consumer durables, and education expenses has also increased. The government has also maintained three "policy banks" to lend to commercially unattractive endeavors such as infrastructure development and government agricultural procurement. Nevertheless, China's commercial banks still carry a heavy percentage of non-performing loans. Authoritative estimates of the total stock of bad debt in China's financial system range from 45 percent to 75 percent of the country's annual gross domestic product. Large SOEs continue to receive the bulk of commercial bank lending, although local financing of FIEs is becoming more widely available.

Exhibit 17

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IMF Working Paper

An Attempt to Profile the Finances of China's Enterprise Sector

Paul Heytens and Cem Karacadag

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IMF Working Paper

Asia and Pacific Department

An Attempt to Profile the Finances of China's Enterprise Sector

Prepared by Paul Heytens and Cem Karacadag[1]

Authorized for distribution by Markus Rodlauer

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Abstract

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper examines the leverage, efficiency, and debt-repayment capacity of the Chinese enterprise sector using aggregate and firm level data. The cash coverage of interest expense, in particular, is used as a bridge between enterprise finances and banks' asset quality in order to develop insights on banking soundness. The interest coverage analysis corroborates the high level of nonperforming loans in the financial system. This underscores the urgency of hardening budget constraints on state-owned enterprises and stemming the flow of new bad loans by accelerating ongoing structural reforms.

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bridge between the enterprise sector analysis and assessment of financial sector asset quality. This measure has provided useful insights into financial sector vulnerabilities elsewhere in the region (Ramos and others, 1998, and Goldman Sachs, 2000), but has not been applied to China.

The remainder of this paper is organized as follows. Section II provides a brief overview of the SOE and financial sector reform measures that have been initiated thus far. Section III presents the analysis of data on China's enterprise sector. Section IV concludes with a discussion of the empirical results and their policy implications.

II. Overview of SOE and Financial Sector Reform

The restructuring of SOEs and the financial sector has been the most difficult of China's structural reforms. The financial performance of SOEs has historically been weak, reflecting macroeconomic and industry-specific factors, including poor management, overstaffing, high debt, outdated products and technologies, an excessive social welfare burden, and high tax rates. SOE losses have required heavy subsidization by the state which, before the start of reform in the late 1970s, was provided by direct budgetary allocations, but thereafter took the form of loans from the SCBs. By the mid–1990s, it became clear that reforms of the SOEs and SCBs could no longer be delayed. Even so, the pace of reform remained conditioned by concerns about social stability, as layoffs from SOEs added to regional income disparities and strained an inadequate social safety net.

The focus of recent SOE reform has been to privatize small enterprises and to commercialize large ones under the principle of "seize the large and release the small." Some progress has been made on hardening budget constraints, and enterprise profitability has improved over the past three years, following the authorities' initiative in 1998 to revitalize medium and large SOEs. Better earnings mainly reflect outside factors such as higher oil prices and interest savings from debt-equity swaps, but durable efficiency gains have been secured through layoffs, a reduced social welfare burden, and by cutting excess capacity.[5]

Financial sector reforms have focused on commercializing SCBs' lending operations. Reforms were initiated by establishing policy banks to relieve the four large SCBs of their policy lending, while taking steps to commercialize and hold the SCBs accountable for their own operations and financial results. A range of reforms were introduced after the onset of the Asian crisis, which included limiting local government interference in bank lending decisions, abolishing the Credit Plan, recapitalizing the SCBs through a Y 270 billion bond issue in 1998, and transferring Y 1.4 trillion of NPLs to four AMCs during 1999-2000. Internal SCB reforms have included the revamping of loan approval and analysis procedures, the introduction of more incentive-based compensation systems, branch rationalization, and staff reductions.

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[5] According to official statistics, the aggregate profits of large- and medium-sized SOEs surged by 135 percent in 2000, to Y 240 billion. Available data through September 2001 suggest that the upward trend in SOE profitability has leveled off.

These efforts, however, have not yet succeeded in ending non-commercial lending to SOEs and their operational inefficiencies. Enterprise management is still weak, outside governance limited, excess labor high, and exit channels for poorly performing SOEs limited. Bank loans satisfy the working capital and investment needs of SOEs, many of which accumulate inventories unlikely to be sold and receivables with little prospect of repayment. Cash-short enterprises then accumulate tax payables and are kept afloat by debt rollovers and new loans from banks, whose capacity to assess and price credit risk remains limited. Even if lenders intended to distinguish good risks from bad ones, corporate accounting practices distort financial statements to a degree that makes it difficult to screen and monitor borrowers.[6]

III. Enterprise Sector Analysis

This section examines two types of data on Chinese enterprises: (i) an aggregate data set for all industrial enterprises, including SOEs, published in the annual *China Statistical Yearbook*; and (ii) data on individual listed enterprises, most of which are state owned. The available data confirm the weak financial condition of the enterprise sector. They also suggest that enterprise finances are vulnerable to considerable downside risk from even a moderate weakening of their business environment. Deficiencies in the quality of corporate financial data, however, warrant some caution in interpreting these conclusions.

The financial condition of enterprises, particularly SOEs, has important implications for banking system soundness, given that SOEs are the predominant users of bank credit. SOEs accounted for over one-half of outstanding credit in 2000, two-thirds of which were of less than one-year maturity.[7] While loans to consumers (currently around 2 percent of total loans) have been growing rapidly in recent years, credit to enterprises will continue to represent a large share of bank assets. The financial system's risk exposure to the enterprise sector should decline over time, however, as a growing share of new credits are granted to private enterprises and banks lend on an increasingly commercial basis.

[6] Firms overstate profits and assets. All goods produced are valued at market prices, regardless of whether they are sold or paid for. Unsold goods accumulate as inventories, while goods sold but not paid for accumulate as receivables. Both are then valued at market prices and classified as current assets. Furthermore, both inventories and receivables are credited as revenues in the income statement and included in profits, even though neither of them generates cash. Appendix I details the statistical adjustments made to correct for the data anomalies.

[7] It is worth noting that the credit stock—at 127 percent of GDP at end-2000—is high by emerging market standards, reflecting China's high savings rate.

A. Aggregate Level Analysis

Although the share of SOEs in China's industrial sector has been declining, it is still sizable. The share of state enterprise output and employment has been on a declining trend since 1994 (Table 1).[8] Nevertheless, SOEs continue to generate over 50 percent of industrial value-added and employ more than half of the industrial workforce. Also noteworthy is the steady rise in the value-added of foreign-funded enterprises, which doubled between 1994–2000, in contrast to that of collective-owned firms, which fell by more than one half.[9]

SOEs control the bulk of productive assets in the industrial sector. SOEs held two-thirds of the net fixed assets of all industrial enterprises in 2000 (Table 2).[10] By contrast, collective enterprises' share of fixed assets fell by two-thirds between 1994 and 2000, with shareholding and foreign companies increasing their shares modestly. The decline in the share of collectives is attributable to falling growth and investment of township and village enterprises (which are classified as collectives), and because many collectives were actually private and were reclassified as such in 1998. A noteworthy trend is the rising share of fixed assets in the total assets of all enterprises, particularly that of SOEs. The share of net fixed assets in SOEs' total assets stood at 44 percent in 2000, up from under 36 percent in 1994.

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[8] The jump in SOEs' share of industrial value-added in 1998 (as well as in their share of industrial fixed assets—Table 2) resulted in part from a broadening of the classification to also include enterprises in which the state has a controlling share. In addition, it may reflect the impact of increased fiscal spending—which was largely channeled through SOEs—to support growth following the Asian financial crisis.

[9] Shareholding companies doubled their share of industrial value-added in both 1999 and 2000, but the increase in part stems from the reclassification of firms out of collective- or state-owned and into shareholding companies.

[10] The increase in SOEs' share of fixed assets may also reflect (in addition to the broadening of classification noted in footnote 8) a pickup in "technological renovation" investment following the authorities' plan adopted in 1998 to rehabilitate large SOEs.

Table 1. Output, Employment, and Value-Added of Industrial Enterprises, 1994–2000

	1994	1995	1996	1997	1998	1999	2000
Output				(Percent of total)			
State-owned 1/	37.8	34.6	34.0	30.2	26.5	26.3	...
Collective-owned	38.2	37.3	36.9	36.4	36.1	32.9	...
Individual-owned	10.2	13.1	14.5	17.1	16.1	16.9	...
Shareholding	4.3	3.1	3.1	4.2	7.3	9.1	...
Foreign-funded 2/	9.6	11.9	11.4	12.1	14.0	14.8	...
Employment				(Percent of total)			
State-owned 1/	66.4	66.5	66.3	65.0	57.2	54.5	51.1
Collective-owned	24.4	22.7	22.2	21.4	16.9	15.2	13.7
Other	9.2	10.7	11.5	13.6	25.9	30.3	35.2
Value-added				(Percent of total)			
State-owned 1/	54.5	54.5	49.4	47.3	58.3	55.7	51.9
Collective-owned	28.4	25.4	29.2	27.1	17.4	14.6	11.6
Shareholding	5.8	5.1	5.4	7.4	3.0	7.4	13.5
Foreign-funded 2/	11.3	15.0	16.1	18.2	21.3	22.3	23.0

Sources: *China Statistical Yearbook*, various issues. 1/ Including enterprises with a controlling share by the state for 1998–2000. 2/ Including Hong Kong SAR, Macao SAR, and Taiwan Province of China.

Table 2. Net Fixed Assets of Industrial Enterprises, 1994–2000

Net Fixed Assets	1994	1995	1996	1997	1998	1999	2000
				(Percent of total)			
State-owned 1/	65.7	64.4	64.9	62.4	71.3	68.1	65.4
Collective-owned	16.9	15.8	14.9	13.9	8.6	7.2	5.8
Shareholding	5.2	4.7	4.9	6.7	1.5	6.6	11.4
Foreign-funded	7.2	6.6	7.8	9.2	9.3	9.4	9.3
Hong Kong SAR, Macao SAR, and Taiwan Province of China	5.1	8.4	7.6	7.8	9.3	8.8	8.1
				(Percent of total assets)			
State-owned 1/	35.5	36.8	42.0	41.5	42.6	42.2	43.9
Collective-owned	29.5	29.9	32.3	33.0	33.9	33.9	33.9
Shareholding	26.0	28.8	30.3	32.2	34.3	35.7	43.2
Foreign-funded	36.6	31.1	33.0	35.3	37.9	38.6	37.9
Hong Kong SAR, Macao SAR, and Taiwan Province of China	32.3	36.6	37.7	39.0	40.2	40.1	38.4
All enterprises	33.6	34.7	38.4	38.5	40.8	40.5	42.0

Source: *China Statistical Yearbook*, various issues. 1/ Including enterprises with a controlling share by the state for 1998–2000.

However, the efficiency of investment in the SOE sector is relatively low (Figure 1). The ratio of value added-to-fixed assets for SOEs was 37 percent in 2000, compared with 56 percent for shareholding companies, 61 percent for foreign companies, and 94 percent for collectively-owned firms. Although the efficiency of all groups fell during 1994-2000, the relative drop in this ratio was sharpest for SOEs, at 35 percent.

Exhibit 18

China in the World Economy

THE DOMESTIC POLICY CHALLENGES

SYNTHESIS REPORT

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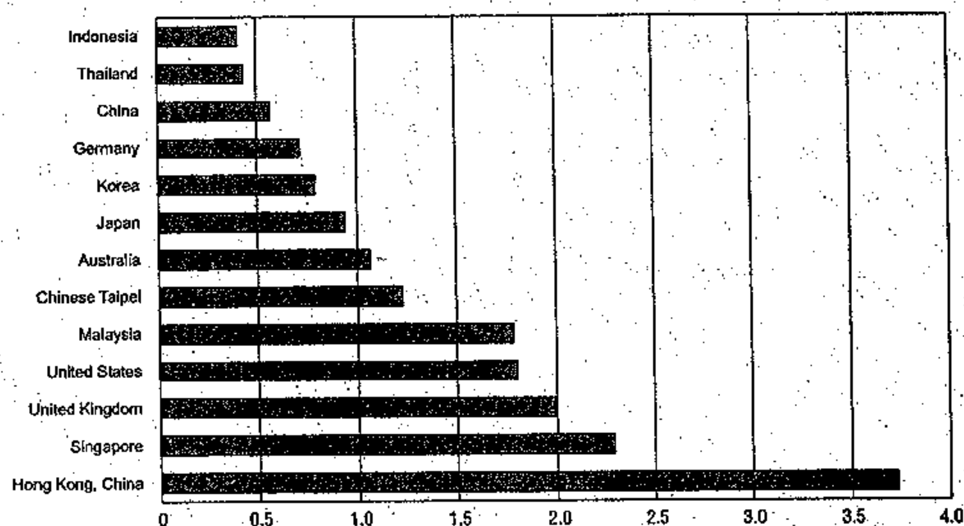
China in the World Economy: The Domestic Policy Challenges

SYNTHESIS REPORT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Figure 3. **Equity market capitalisation: ratio to GDP in selected countries, 2000**



Note: Figure is from Chapter 15, Figure 15.1.
Source: International Federation of Stock Exchanges and OECD Secretariat Estimates.

Growing constraints from the financial system[9]

China's financial system has made important progress in recent years. The stock market has expanded impressively since its inception in the early 1990s, reaching a market capitalisation of more than 50 per cent of GDP by 2001 (Figure 3). The past decade has also seen the creation of new nation-wide banks, significant expansion of the insurance sector, development of a domestic money market, and the more recent emergence of consumer and housing finance. The financial supervisory and regulatory structure has also been thoroughly reorganised and rationalised along lines consistent with international best practices.

Despite this progress, the financial system still performs inadequately in carrying out several of its basic functions in the economy. Although savings appear to be mobilised reasonably effectively,[10] credit is inefficiently allocated. SOEs receive the bulk of funds allocated by the formal financial system, while non-state enterprises receive a much lower share than warranted by their importance in the overall economy.[11] Non-commercial considerations, such as the need to sustain loss-making SOEs, continue to influence bank lending. These distortions, together

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with the limited ability to vary interest rates to reflect risk, mean that the effective cost of credit varies widely among borrowers of comparable credit worthiness. There is limited diversity in financial outlets and capabilities. The interbank market and other available facilities provide only limited scope for transferring funds among financial institutions or regions. Insurance companies and other institutional investors are underdeveloped even compared with other emerging market economies such as India and Brazil. The government and other bond markets are small, fragmented, and illiquid, and the stock market, despite its rapid growth, is subject to limitations on access and trading that impair its effectiveness. Financial instruments to deal with liquidity fluctuations, manage risk, and provide for other specialised needs are limited.

The external discipline provided by the financial system has also been a major weakness. Years of government-mandated lending together with weak contract enforcement and bankruptcy regimes created a distorted credit culture in which banks have had limited incentives – and even less ability – to maintain strict lending standards and enforce loan contracts. Government mandates and weak lending standards created "soft budget constraints" for many enterprises that were a major factor in the over-investment that occurred during 1992-94, and whose legacy of excess and inefficient capacity now afflicts the Chinese economy. The overall weakness in discipline has been aggravated by its unevenness across enterprises. Due in part to the limited development of capital markets, but also to government intervention in enterprise operations, the financial system lacks means to support enterprise restructuring, re-deploy resources, and provide a market for corporate control.

These weaknesses in the financial system are partly a reflection of the fact that China is still a developing country. However they also reflect the fact that evolution of the financial system has lagged that of the real economy. Despite the substantial growth of the non-state sector in the real economy, the financial system remains virtually entirely state-owned (Table 4), with only a single privately owned domestic bank. The four major state-owned commercial banks (SOCBs) established in the early reform period to finance SOEs, and which are still heavily oriented toward this enterprise segment, dominate the financial system, accounting for nearly three-quarters of domestic lending. Credit facilities are segmented between the cities and rural areas. Operations of most commercial banks, with the exception of the SOCBs and 13 newer joint-stock banks, are restricted to their home city.

These structural features reflect the heavy past involvement of the government in lending decisions to support central planning mandates in the real economy and to use bank lending as a substitute for government spending to promote various non-commercial objectives. The latter practice was spurred in part by the steady decline in government tax revenues from the early 1980s through the

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Table 4. **State ownership of banks**

	State owned or controlled banks: share of banking system capital	
	1998	1994
China	99	100
Other emerging economies:		
Hong Kong, China	0	0
India	82	87
Indonesia	85	48
Malaysia	7	9
Philippines	n.a.	19
Singapore	0	0
Thailand	29	7
Russia	36	n.a.
Argentina	30	36
Brazil	47	48
Chile	12	14
Mexico	28	0
Peru	0	3
South Africa	2	2
OECD *countries:*		
Australia	0	22
Canada	0[1]	n.a.
France	0[2]	n.a.
Germany	47	50
Italy	17[1]	n.a.
Japan	15	0
United Kingdom	0[1]	n.a.
United States	0	0
Czech Republic	19	20
Hungary	9[1]	81[3]
Poland	46	76

1. 1999.
2. The government has a controlling interest in several financial institutions that provide services similar to those of commercial banks.
3. 1990.

Sources: Chan-Lee, James with Sanghoon Ahn (2000), *Measuring the quality of financial systems in 29 market economies: an indicators approach with an extension to East Asia*, Asian Development Bank Institute, July; Barth, James R., Gerard Caprio Jr., and Ross Levine (2001), *The regulation and supervision of banks around the world: a new database*, World Bank, February; national sources and secretariat estimates.

mid-1990s (see Chapters 18 and 22 on tax policy and macroeconomic issues respectively). The resulting substitution of government mandates for sound credit standards is substantially responsible for the massive accumulation of non-

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performing loans by banks and other financial institutions. Government involvement, and the perception that financial institutions will ultimately be backed by the government regardless of their performance, has also inhibited the development of a commercially oriented internal culture focused on the maintenance of sound lending standards and rigorous management of risks.

Beginning in the mid-1990s, the pace of financial reform has accelerated sharply in an effort to address the system's weaknesses. The banking law enacted in 1996 led to a significant tightening of bank lending standards by improving internal controls and strengthening accountability by holding bank loan officers and their management responsible for new problem loans. This step, together with the earlier establishment of three "policy banks", was intended to free commercial banks from government mandates. In 2000, authorities transferred RMB 1.3 trillion (about US$ 150 billion) of SOCB non-performing loans (NPLs), amounting to nearly 18 per cent of their total loans, to bank asset management companies (BAMCs). New joint-stock banks with nation-wide scope have been established since 1995 in order to create more diversity in the financial system. Authorities have also sought to reduce restrictions on the joint-stock banks to encourage their development and are planning to introduce governance reforms for SOCBs.

However, while important, these steps have not proved sufficient to remedy the weaknesses in financial system capabilities. Credit quality has improved but a large portion of SMEs now face a virtual credit crunch. While many of these enterprises are in poor financial condition, surveys suggest that lack of access to funding has become a key impediment to SME restructuring. Financial discipline has become if anything more uneven than before, as large SOEs with government backing continue to have good access to bank credit and have been the main beneficiaries of the additional financing provided by the stock market. Government intervention in lending decisions has been reduced but the continued provision of working capital loans to poorly performing SOEs suggests it has not disappeared. Furthermore, while the tightening of lending standards helps to contain new non-performing loans, it is unlikely to be sufficient to foster the managed risk-taking characteristic of commercially oriented financial institutions, and which will be increasingly needed in China to facilitate the adjustments to trade and investment liberalisation.

Financial weakness has made these problems all the more difficult to deal with. Despite the carve out of non-performing loans in 2000, the SOCBs along with many other financial institutions almost certainly would have negative capital if their loan portfolios were valued realistically. non-performing loans remaining with the SOCBs after the transfer of loans to BAMC were nearly 27 per cent of total loans in mid 2001 according to official figures, and would probably be higher if the international accounting and loan classification standards China is gradually introducing were fully applied. Joint stock banks also have high non-performing loans

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Improving the competition framework[36]

By some standard indicators, China's product markets appear to be reasonably competitive: market concentration at the national level is relatively low; and there has been substantial entry of new firms. Economic rivalry is fierce in many sectors. These measures are deceptive, however, because the limits to competition in China are manifest in other ways. Government restrictions are more prominent as barriers to competition. Limited transport facilities, local protectionism, and other barriers to geographic integration allow enterprises to exercise monopoly power in local markets to a degree that is not apparent in national concentration ratios. Moreover, as noted earlier, competition is uneven across sectors.

The main weaknesses in the competitive environment in China can be listed as follows.

- As has happened in other countries, established enterprises and local governments often seek to prevent entry by newcomers and thereby extract monopoly rents. Product market competition is limited in some cases by overt barriers, by distortions in the tax code and distribution system, and, probably most importantly, by locally imposed restrictions on outsider's ability to establish or acquire a local business.[37]
- The different legal and regulatory frameworks applying to state-owned, collective, private and foreign enterprises, along with complex and opaque requirements for business establishment and business scope, often limit competition. Examples include the high minimum capital required of private limited companies and their need to undergo an elaborate regulatory approval process to make even modest changes in their lines of business.[38]
- While prices are reasonably free to vary for most products and markets, they continue to be restricted in some, notably energy and tobacco. The temporary price floors imposed in industries with excess capacity also limit competition as well as impede exit.
- A substantial number of key sectors are wholly or mainly reserved to SOEs, including not only natural monopolies but, as noted earlier, automobile and steel production. Authorities plan to reduce the role of SOEs to "strategic sectors" but have not specified what those sectors will be.

The present competition law framework rests on the 1993 Unfair Competition Law and the 1999 Price Law, together with various specific regulations and decrees banning certain regional protectionist practices. These laws are enforced by the State Administration for Industry and Commerce (SAIC) and the State Development Planning Commission (SDPC). Together these laws outlaw some overt anticompetitive practices, such as price fixing, and prohibit unauthorised actions by local government agencies or officials that prevent competition. However these

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Exhibit 19

Management of China's State-Owned Enterprises Portfolio: Lessons from International Experience

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World Bank Office, Beijing

September3, 2003

Executive Summary

Analysis of China's portfolio of 174,000 state-owned enterprises (as of end-2001) reveals a clear split. China has some reasonably profitable large SOEs, many of which are centrally administered and/or publicly listed – including some on the Hong Kong and New York stock exchanges. But just over half of China's SOEs are loss-making. The great majority of loss-makers are small/medium SOEs. Locally-administered SOEs pose significant risks of a "localization of benefits" (e.g., wages) and a "nationalization of liabilities" (e.g., additional bank re-capitalization requirements for non-performing loans, un-funded pension liabilities). Thus, China's SOE portfolio poses two issues for the management of State capital. First, what should be done with the cash generated through dividends or proceeds from the sale of relatively good SOEs? Second, what should be done to contain operating losses and the creation of new liabilities from China's many bad SOEs?

A modern capital management system The preservation and enhancement of State capital will require implementation of a " modern capital management system" through (a) more widespread accounting and auditing reforms; (b) a segmented approach to the management of SOE portfolios; (c) a systematic approach to SOE dividend policy and capital re-investment; (d) central/local agreement on sharing of proceeds and curtailment of liabilities; and (e) enhanced risk management:

(a) Accounting standards now applied to listed companies and foreign-invested enterprises should also be applied to all medium/large SOEs. It would be useful for all large SOEs to experience the *discipline* of a public share offering (including the accounting standards, public disclosure, controls on related party transactions, and independent directors) – even including large SOEs that are *not* suitable for a public share offering. There should be a regular accounting for the central State Assets Supervision and Administration Commission (SASAC) portfolio and the portfolio of each local SASAC. Financial reporting for each SASAC portfolio should similarly reflect international accounting standards, with due consideration for unique Chinese circumstances. Improved management information systems should enable SASAC portfolio managers to focus on key portfolio performance measures. Given the "public" nature of SOEs, including those that are not publicly-listed on stock exchanges, it would be appropriate to increase the transparency of all large SOEs and SASAC portfolios – e.g., by requiring quarterly and annual financial statements and making these available to the public.

(b) It would also be useful for the central SASAC to develop guidelines for segmenting SOE portfolios and managing portfolio segments accordingly. Likely portfolio segments include the following:

- Small/medium SOEs ready for near-term ownership transformation;
- Medium/large SOEs in need of operational and/or financial restructuring;
- Medium/large SOEs whose business is non-viable, which should be liquidated; and
- Reasonably healthy large SOEs suitable for "normal" corporate governance.

II. China's Current Portfolio of State Owned Enterprises (SOEs)

A. Overview of the Portfolio

Between 1997 and end-2001, the number of SOEs decreased by 88,000 – from 262,000 to 174,000 (Table II-1). This decrease has largely been driven by administrative actions: privatizations, "capital structure optimization program" bankruptcies, and mergers or acquisitions (M&A). Local governments have continued to administer about 90% of China's SOEs. During this period, SOE assets have grown significantly – especially among centrally-administered SOEs. The average asset size of centrally-administered SOEs has more than doubled since 1997. Almost all of the overall growth in SOE assets is due to increases in fixed assets and current assets (e.g., receivables, inventory). Some significant part of these increases may be due to SOE M&A transactions.

Table II-1. SOEs and SOE Assets, 1997 and 2001

Amounts in RMB millions

	SOEs			Assets			Average Assets	
	Central	Local	Total	Central	Local	Total	Central	Local
1997	26,000	236,000	262,000	4,862,440	7,635,080	12,497,520	187	32
2001	17,000	157,000	174,000	7,321,100	9,349,860	16,670,960	431	60

Source: *Financial Yearbook of China 2002.*

Of 173,504 SOEs at end-2001, just 9,453 are large while the other 164,051 are medium/small (Table II-2). Small SOEs are especially common in agriculture, food-processing and machinery, commerce (trade, commercial brokerage, catering), and transport. These activities account for 86,633 small SOEs – almost two-thirds the small SOE total. Enterprise workforces average 200 or less in in several sectors: e.g., food processing, urban utilities, transport, commerce, and real estate. Of 48.1 million SOE workers, 15.2 million are at centrally-administered SOEs while 33 million are at locally-administered SOEs. As of end-2000, the state was the majority shareholder in 1605 enterprise groups which accounted for perhaps 13,000+ SOEs.[1]

The distinction here between centrally and locally-administered SOEs has somewhat been overtaken by events. It has recently been announced that the central SASAC would oversee the governance of 196 SOEs with combined assets shown at RMB 2.5 trillion.[2] Most of these SOEs are quite large and have a substantial number of subsidiaries or affiliated enterprises. Other SOEs would presumably be governed by local SASACs. Despite this recent change, the distinctions made here in terms of enterprise size,

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[1] Enterprise Survey Team, " Development of Enterprise Groups in China," 2001. Figure of 13,000+ is based on a nationwide average of 8.3 subsidiaries per enterprise group.

[2] http://www.people.com.cn/GB/jinji/31/179/20030522/998247.html

Economic growth, debt/equity conversions by AMCs, and other decreases in interest expense have presumably contributed to improved profitability. But SOE privatizations, mergers, and bankruptcies may have been more important. Notably, the 84,000 decrease in loss-making SOEs since 1997 almost equals the 88,000 decrease in total SOEs. However, 51% of SOEs were still loss-making in 2001. For 2001, China's SOEs showed RMB 281 billion in overall profit, with profitable SOEs contributing RMB 480 billion and loss-making SOEs destroying RMB 199 billion in value. In addition, a high and increasing level of current assets-to-sales indicates an SOE liquidity problem. Current assets have increased to 313-325 days of sales since 1997. Unless SOEs are maintaining large cash balances, which seems unlikely, this suggests that increasing amounts of working capital are tied up in possibly un-collectible receivables and un-saleable inventory.

Table II-3. SOE Profitability and Liquidity, 1997-2001

Amounts in RMB millions

	1997	1998	1999	2000	2001
Sales revenue	6,813,200	6,468,510	6,913,660	7,508,190	7,635,550
SOE profits	n.a.	328,020	329,070	467,980	480,470
SOE losses	n.a.	(306,650)	(214,490)	(184,600)	(199,360)
Net profit	79,120	21,370	114,580	283,380	281,120
Net profitability	1.2%	0.3%	1.7%	3.7%	3.7%
Percentage loss-making	65.9%	68.7%	53.5%	50.7%	51.2%
Profitable SOEs	89,000	74,000	101,000	94,000	85,000
Loss-making SOEs	173,000	164,000	116,000	97,000	89,000
Total SOEs	262,000	238,000	217,000	191,000	174,000
Current assets	5,369,850	5,575,110	5,935,170	6,682,560	6,678,560
Current asset-days 1/	288	315	313	325	319

Source: *Financial Yearbook of China 2002.*
1/ Represented as days of sales.

SOE profitability varies by locality. In 2001, over 60% of SOEs in Beijing and Shanghai were profitable (Table II- 4). By contrast, over 60% of SOEs were unprofitable in the northeast provinces of Liaoning and Jilin; the central provinces of Anhui, Henan, and Hubei; the southwestern provinces of Guangxi, Hainan, Chongqing, Sichuan, and Yunnan; and the northwestern province of Gansu.

B. Implications for State Asset Management

The split nature of China's SOE portfolio – some reasonably profitable large SOEs and many distressed SOEs of all sizes, but mostly small or medium – has important implications for implementation of the state asset management reforms mandated by the 16th CPC Congress and the 10th National People's Congress:

1. Additional reforms are needed to facilitate not just more efficient use of State capital, but its actual preservation.
2. Up to 150,000 small and medium SOEs should be "let go" within the next five years – a huge task that will require efficient approaches to ownership transformation and restructuring or liquidation.
3. Resolution of large numbers of distressed SOEs will require market-based allocations of losses plus more capacity to do operational and financial restructuring.
4. While central SASAC may be able to focus on SOE governance, local SASACs will need to focus more on SOE ownership transformation and restructuring.

1. State capital

China's SOEs pose two issues for the management of State capital. First, what should be done with the cash generated through dividends or sales proceeds from relatively good SOEs? The second is less pleasant – i.e., how to contain and share operating losses, losses on sale, and restructuring losses from China's many bad SOEs?

Historically, China's SOE sector has overwhelmingly emphasized jobs preservation over the efficient use of capital. This is clear from such indicators as the maintenance of 89,000 loss-makers in the SOE portfolio, the progressive de-capitalization of at least ten sectors, and the insolvency of five provincial SOE portfolios. From the earlier description of locally-administered SOEs, there appears to be a significant " localization of benefits" (e.g., preservation of jobs, " leaking out" personal gains) leading to a "nationalization of liabilities." These national liabilities are almost certain to include *additional* requirements for the eventual re-capitalization of state banks, to cover losses from non-performing loans (NPLs) to SOEs, and for the National Social Security Fund (NSSF) to cover local social insurance shortfalls for workers.

Thus, the most urgent task is preservation of State capital. The prompt sale of small/medium SOEs is likely to be the most obvious way of mitigating the risk of "localization of benefits – nationalization of liabilities." Also urgent is the restructuring or liquidation of distressed or non-viable SOEs. The process of selling or restructuring SOEs, however, will precipitate the recognition of losses from excess claims and require some resolution.

Dividends and sales proceeds from good SOEs will provide some financial resources to cover claims. In at least some provinces, however, local financial resources will probably not suffice to cover claims.[6] Thus, it will be important for the central and local

[6] This applies both to privatization and liquidation. Most often, claims on an enterprise are paid out of sale proceeds or enterprise assets. Excess pools of financial resources – e.g, to satisfy financial institution

Exhibit 20

NAM National Association of Manufacturers

September 10, 2003

REVIEW OF CHINA'S COMPLIANCE WITH ITS WTO ACCESSION COMMITMENTS

COMMENTS SUBMITTED TO THE INTERAGENCY TRADE POLICY STAFF COMMITTEE BY THE NATIONAL ASSOCIATION OF MANUFACTURERS

Areas of Concern

- Currency undervaluation
- Subsidized exports
- Counterfeiting and IPR violations
- Discriminatory VAT taxes
- Unjustified product labeling requirements
- Inappropriate standards and concerns about CCC mark procedures
- Restrictions on trading rights
- Lack of action on auto financing regulations
- Problems with Tariff Rate Quotas
- Slow progress on transparency

Overview

The National Association of Manufacturers (NAM) welcomes the opportunity to comment on China's compliance with obligations accepted as a WTO member and commitments made in conjunction with accession to open its internal market to foreign products and services. The NAM supported China's membership on the condition that it would take meaningful steps to adhere to these obligations and commitments and become a responsible participant in the international trading system.

Trade with China is of immense importance to many U.S. manufacturers. The Chinese market is set to become one of the largest in the world within the next several years. Chinese imports are expected to exceed $380 billion in 2003, making China the world's third largest importer after the United States and Germany. At the same time, China is rapidly becoming a major exporter of industrial goods, and the range of industrial products exported has continued to grow at a rapid pace. China's expanded participation in the global marketplace, then, offers both important new commercial opportunities as well as challenges resulting from increased competition in the U.S. and foreign markets.

NAM members want the United States to have a positive trade relationship with China. However, they also want a level playing field for competition. In that regard, we are hearing increasing concerns about unfair Chinese trade and currency practices and China's failure to provide the same kind of access to U.S. goods and services in the Chinese market that Chinese goods and services enjoy in the U.S. market.

isocyanurates, which is used as a cleaning agent in swimming pools, reports a similar situation. As a result of pricing which appears to be below cost, Chinese exporters are expected to increase exports of this product by 400 percent in 2003 over 2002 levels.

These reports suggest the likelihood of widespread use of subsidies, either direct or indirect, to help Chinese exporters gain unfair competitive advantage in the U.S. market. They merit further investigation by USTR and the Department of Commerce. One source of indirect subsidy is continued bank lending to money-losing and insolvent Chinese manufacturers, often state-owned or state-controlled enterprises. Since the Chinese banks providing these loans are either state-owned or state-controlled, the Chinese government bears responsibility for their lending practices. U.S. steel producers note that the Chinese steel industry is the largest-recipient of interest-rate subsidies authorized by the national government. Since many of the companies that benefit from either directed bank lending or subsidized interest rates are engaged in international trade, they have an unfair competitive advantage vis-à-vis U.S. based companies, which must rely on private financing at market rates.

Counterfeiting and Ineffective Enforcement of IPR Protection

While Chinese laws on intellectual property rights (IPR) have improved considerably, the lack of effective enforcement of the IPR protection remains a serious problem. Violations of trademarks through product counterfeiting is rampant and on a massive scale. The violations involve a wide range of products, including consumer hygiene and health care products, athletic footwear, pharmaceuticals, food and beverages, motorized vehicles and even entire automobiles. Pharmaceutical counterfeiting is now, according to U.S. industry representatives, a serious public health concern in China. We believe that the lack of criminal penalties for counterfeiting, including jailing, prevents effective enforcement of trademark and labeling violations.

We are also concerned about reports that local government authorities are actually promoting the expansion of local industry dedicated principally to counterfeiting. At a minimum, local authorities are knowledgeable of counterfeit production and taking no action to halt it. There appears to be no mechanism for the national government to prevent local governments from aiding and abetting counterfeiting by local industry. In addition, the Chinese customs service has not cooperated in blocking exports of counterfeit products even when solid evidence of counterfeiting was provided. It is claimed that, since the "exporting" of counterfeit products does not constitute a "sale" of the products, the relevant Chinese law did not apply.

Other IPR violations are also common. They include unauthorized duplication of computer software, music and films; copying of designs; unauthorized use of patented technology; and unauthorized use of U.S. product certification logos. The makers of air conditioning and refrigeration equipment note that the ARI (Air-Conditioning and Refrigeration Institute) certification symbol was being used without authorization by a Chinese company. Efforts to have the Chinese government stop this unauthorized used proved ineffective.

Inappropriate standards and concerns about CCC mark system

Several NAM members have raised concerns about application of technical standards and the CCC Mark system. With regard to standards, China is requiring that certain products (e.g., electrical products) be manufactured only to "international standards" as determined in the ISO or IEC. Other "international standards," notably those developed in the United States and widely used in the global marketplace, are not allowed. This does not conform with the WTO TBT Committee interpretation that "international standards" need not be limited to ISO or IEC standards.

A second set of standards concerns relates to the CCC mark system. China introduced the CCC mark system to comply with WTO requirements for a single mark for like domestic and imported products. It is, in that sense, a step forward on standards and mark requirements. However, the inconsistent, non-transparent and inflexible application of the CCC Mark on a variety of products (e.g., electrical products, air conditioning and refrigeration equipment, and tires) has created market access barriers and needlessly raised the cost of importing products into China.

Generic problems include: the high cost of having Chinese inspectors audit factories in the United States and other foreign countries on compliance with the standards; continued delays in allowing U.S. testing and certifying bodies to certify compliance for the CCC mark; and lengthy delays and relatively high cost of obtaining testing and certification for the CCC mark in China.

Several other specific problems were noted. A major tire company reported that several types of its bus tires that are standard sizes in countries around the world cannot obtain the required CCC mark because these sizes are not listed in the Chinese National Standards. Another type of tire used widely on Chinese trucks is also not on the list and thus cannot be sold by the U.S. company in China. Efforts to resolve this problem with Chinese standards authorities and Chinese customs have thus far been unsuccessful. In addition, the company reports that local inspection offices appear to be abusing their authority by requiring the re-inspection of the company's Chinese-produced tires and confiscating tires which the determine to be "non-compliant" with the CCC mark standards.

Restrictions on Trade Rights of Joint Ventures

China is not fulfilling its commitment to allow foreign joint ventures to import and sell products (e.g., tires, automobiles, auto parts and industrial equipment) in China, which was to have gone into effect on Dec.10, 2002. A major tire company, for example, reports that the Chinese government has imposed additional restrictions on its trading rights that were not anticipated when this concession was negotiated. They include allowing only new joint ventures to have this right and requiring the Chinese and foreign partners to have separately done U.S. $30 million in trade with China over each of the three preceding years.

Lack of action on auto financing regulations

The Chinese government has committed to publish new regulations governing the financing of automobile purchases. Several NAM member companies have expressed concern about slow progress on the regulations that were explicitly promised in China's accession agreement. The U.S. government should press for their prompt issuance to comply with WTO obligations.

Problems with Tariff Rate Quotas and Import Certificates

Complications in implementing tariff rate quotas (TRQs) are creating non-tariff trade barriers to U.S. feed products, notably corn and wheat. Chinese authorities have delayed issuance of regulations on the administration of the TRQ system and introduced unreasonable licensing procedures. There has also been a lack of transparency in the process which makes it difficult to know which companies are granted quotas. China has also violated its accession agreement by redirecting quotas reserved for non-state companies to state-owned companies.

A related problem that has affected soybean exporters is the narrow window for using import permits under the AQSIQ permit system. U.S. exporters have only 90 days to purchase, transport and unload their products in China. These restrictions are not only limiting U.S. commodity exports sales but also restricting the operation of soybean processing plants in China.

Lack of Transparency in Trade Regulatory Process

Many companies complain about the lack of transparency in the trade regulatory process and the difficulty in obtaining current laws and regulations governing trade and business operations. This is a continuing problem that should lend itself to solutions in a relatively short time frame. The U.S. government should press for concrete steps that improve transparency at all levels.

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Exhibit 21

HEARING ON CHINA'S IMPACT ON THE U.S. MANUFACTURING BASE

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

JANUARY 30, 2004

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The Commission's Statutory Mandate begins on page 151.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

MARCH 4, 2004

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

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our field investigation in Columbia, South Carolina on January 30, 2004. This field investigation titled, "*China's Impact on the U.S. Manufacturing Base,*" gave the Commission the opportunity to examine the real, on-the-ground impacts of fast increasing Chinese imports and off-shore transfers by U.S. firms on the U.S. manufacturing base.

This investigation revealed the extent of the difficulties faced by America's manufacturers, workers and communities in the face of manufacturing competition from China and the urgent need for action to deal with them. The location was vital to the message. According to U.S. Department of Labor statistics, between November 2002 and November 2003, Columbia, South Carolina lost 12,000 jobs, which represents a 4 percent decrease, the largest percentage of jobs lost that year for any metropolitan area in the United States. The State of South Carolina lost 2.6 percent of its jobs over that same time period, the largest percent decrease of any State. In the manufacturing sector, South Carolina has lost 63,000 jobs, a nearly 20 percent decline over the past three years.

Representing bipartisan Congressional concerns about this matter, Senators Ernest F. Hollings (D–SC) and Lindsey O. Graham (R–SC) took part in the proceedings and expressed to the Commission their views regarding what they believed to be China's unfair trade policies, particularly its artificially undervalued currency, as well as export subsidies, dumping, and other WTO-inconsistent practices. Panelists representing South Carolina's manufacturing industries—including textile, apparel, steel and plastics—gave vivid descriptions of the bottom line challenges they face from such Chinese competition.

Unfair Chinese Trade Policies

China's continued rapid growth in manufacturing, U.S. companies' willingness to move production abroad in order to cut costs, often referred to as offshore outsourcing, and China's policies aimed at encouraging growth and investment in its manufacturing base were discussed in depth at this investigation. In assessing causes of the worsening U.S. trade deficit and loss of U.S. manufacturing jobs, participants pointed to China's lack of labor and environmental standards, rampant infringement of intellectual property rights, state subsidization of its state-owned industries through preferential tax treatment, access to capital, and other benefits, and its record of lagging compliance with many important commitments under its WTO accession agreement. These factors have undermined the competitiveness of U.S. manufacturing firms in South Carolina and elsewhere in our country.

Overall, many of the hearing participants were exceedingly critical of the U.S.' trade strategy and policies. Many claimed that policies aimed at promoting free trade were in fact encouraging the transfer of manufacturing and research and development to China to the detriment of the U.S. economy.

Industry Specific Considerations

Steel: Over the last three years South Carolina's steel and metals industry has experienced a dramatic decline. Between November 2000 and November 2003, South Carolina's primary metals and fabricated metals industries lost a combined 7,300 jobs, representing contractions of 20 percent and 18.6 percent, respectively. According to the U.S. Department of Commerce, between 2000 and 2002, South Carolina's exports of primary metal manufactures fell from just over $126 million to approximately $76 million.

Panelists representing U.S. steel firms described the effect of competition from China on their industry. They noted that China's steel industry—which benefits from extensive capital subsidies from China's state-owned banks—has grown 10 percent in the last 12 months resulting in soaring demand for scrap steel and other inputs. One particularly ominous concern expressed by hearing panelists is that a slow down in the Chinese economy could reduce its domestic demand for steel and

rency were fully convertible. The consequences for the U.S. furniture manufacturer competing with the Chinese are obvious. If the currency were subject to valuation by the market rather than being fixed, Chinese goods would be much less competitive in the United States. Our own government adds some odd twists to this. The Treasury Department claims that China isn't manipulating its currency through the convenience of a very narrow definition of the word manipulation. Whether intervention or manipulation, I don't care what you call it, it's clear that they're setting the exchange rate at such a low level it's costing the United States tens of billions of dollars a year in lost sales, lost profits, lost wages, lost tax revenues, higher government expenditures for laid off workers, and it goes on and on. And a minor byproducts of this and not so minor byproduct of this is a laid off worker is certainly less a consumer and is a tax drain, not a taxpayer. The domino effect moves through the economy. I firmly believe that the artificial exchange rate for the Chinese currency is one of the main reasons why the current economic recovery has generated so few new jobs in manufacturing. Even in an improved economy, U.S. manufacturers simply can't compete against Chinese exporters, on top of lower labor and regulatory costs, plus have a wholly artificial 50 percent plus currency advantage. An undervalued Chinese currency doesn't just hurt American companies that compete directly with Chinese exports. It also hurts our suppliers and our customers. Nucor sells steel to furniture manufacturers as well as to companies in dozens of other industries that are losing ground to Chinese imports. As our customers reduce production they cut back on steel purchases from us. If they move out of the country, i.e., move to China, typically they're gone forever. Nucor happens to be the most efficient steel producer in the world, but quite frankly, there's no point in making steel here if we don't have any manufacturing customers that need to buy it. And we certainly aren't going to export that steel into a market protected by an enormously undervalued currency. An undervalued RMB has a second negative effect, one that affects exporting companies even more directly. Just as a cheap currency makes Chinese imports into U.S. less expensive, it makes all U.S. exports to China more expensive. The second economic policy China uses to artificially boost investment is the direction of credit through state-owned banks. The government of China still exerts tremendous control over the allocation of credit. Tens of billions of dollars of loans have flowed from the state-owned banks into state-owned companies allowing them to fund enormous investments and this way the Chinese government created much of the manufacturing capacity that has enabled Chinese manufacturers to swamp the U.S. with low priced imports. The Chinese steel industry has been one of the major recipients of state-directed loans. Just in brief on this, they have added more capacity in the last three years than the entire United States industry has the ability to produce. That capacity will eventually find a home the first time the Chinese economy has a downturn, and we strongly suspect it will start here. In 2001, China joined the WTO and they are a member also of the International Monetary Fund. They have a certain obligation to abide by WTO principles and rules when they join. They have not. They've gained an enormous advantage

Exhibit 22

American Iron and Steel Institute

Written Statement for the Record of The American Iron and Steel Institute

on

United States-China Economic Relations

Submitted to the House Committee on Ways and Means

November 3, 2003

saturated global market. That, in turn, could cause significant harm to world steel markets, including serious damage to the U.S. steel industry recovery.

China continues to implement a range of policies in the steel sector that, whether WTO illegal or not, distort the market and could result in injury to the U.S. steel industry. These measures traditionally include:

- Massive subsidies provided through export and import substitution programs;
- State-orchestrated mergers and debt-for-equity swaps;
- Encouragement of output restraint cartels;
- Rebating of a value added tax in a manner designed to foster exports in a number of designated sectors, including steel.

Of particular concern is that many Chinese steel companies -- at least 65 by the end of 2002 -- remain under the de facto control of the government. These state-owned-enterprises (SOE's) accounted for around 50 billion RMB (about $6 billion) in capital expansion expenditures in the Chinese steel industry in 2002, which continued to contribute to the Chinese steel industry's overcapacity in key steel product lines.

Low-interest-rate financing continues to be a concern in China's steel industry. The government of China recently targeted six industries to receive interest-rate subsidies, including steel, which was the largest recipient of the interest-rate subsidy. Both private and state-owned steel companies continue to have access to low-cost funds from state-owned banks that have a strong incentive to lend to a "designated industry" such as steel. Another area of concern is the Chinese government's intervention in the domestic price-setting mechanism. This interference has caused steel prices in China to fluctuate widely in a manner that does not accord with market economics.

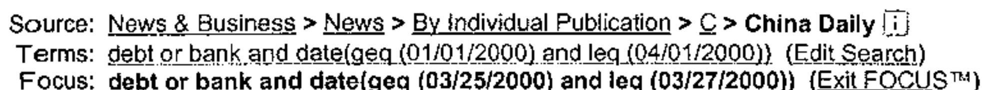
*

China, the world's largest steel producing and consuming nation, has the potential to be the most disruptive force in world trade in steel and many other products going forward. Therefore, the extent to which China is -- or is not -- playing fairly by the rules is of extreme importance to steel and other U.S. industries.

China and the OECD Steel Negotiation

Negotiations are currently underway in the OECD to conclude a multilateral Steel Subsidies Agreement ("SSA"). An SSA would establish multilateral disciplines on steel subsidies, which would augment those in the existing WTO agreements. In these negotiations, China has insisted that it be relieved of some of its WTO obligations as the "price" of Chinese accession to the SSA. This is totally unacceptable and politically

Exhibit 23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CHINA DAILY March 26, 2000

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CHINA DAILY

March 26, 2000

LENGTH: 427 words

HEADLINE: China: **Debt**-to-equity swaps help steel makers

BODY:

The Chinese Government will continue to implement **debt**-to-equity swaps involving billions of US dollars to help steel enterprises significantly trim their **debts** this year.

This will be a big boon for **debt**-stricken steel enterprises struggling for profits, said Wang Xiaoqi, director of the Development and Planning Department under the State Administration of Metallurgical Industry.

Thirty-seven steel enterprises are expected benefit from about 62.5 billion yuan (US$ 7.53 billion) in **debt**-to-equity swaps this year, the most crucial stage in the country's State-owned enterprise reform.

The State Economic and Trade Commission has recommended the enterprises that could benefit from swaps to financial asset management companies.

Wang told Business Weekly the enterprises look forward to the swaps and minimizing their **debts.**

"Although these enterprises now suffer from heavy **debts** left over from the planned-economy era, they still have promise because they are capable of making competitive products for the international market with advanced equipment," Wang said.

Their operational mechanisms meet the requirements of modern enterprise systems, he said.

They are expected to sign the swap agreements by the end of May.

Last year, seven enterprises, including Shanghai-based Baoshan Iron and Steel Group Corp, Anshan Iron and Steel Group Corp in Northeast China's Liaoning Province and Taiyuan Iron and Steel Co Ltd in North China's Shanxi Province, signed agreements valued at 27.5 billion yuan (US$ 3.31 billion) with the Cinda and Huarong Asset Management corporations.

"The swap will enable the enterprises to temporarily improve their financial situations and will be conducive to their long-term development," Wang said.

The steel enterprises will be freed from having to pay 4 billion yuan (US$ 481million) in interest payments this year.

"But the swap is not a panacea, and the enterprise must depend on themselves to sharpen competitive edges."he said

Experts said the government has done all it can to shore up the State-owned enterprises.

The most pressing task for the steel enterprises this year is to control total output and increase their profits, Wang said.

The steel sector is aiming for a 10 per cent output reduction and 10 billion yuan (US$ 1.20 billion) in profits this year.

The sector's painstaking efforts to fulfil the target have been paying off. Hundreds of small steel plants have been shut down. Large and medium-sized enterprises have discarded a lot of their backward equipment.

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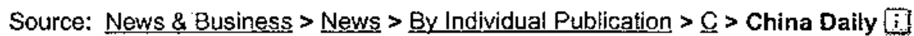

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Exhibit 24

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September 10, 2003

Ms. Gloria Blue
Executive Secretary
Trade Policy Staff Committee
ATTN: China WTO
Office of the United States Trade Representative
1724 F Street, NW
Washington, DC 20508

Re: Request for Comments and Notice of Public Hearing Concerning China's Compliance with WTO Commitments

Dear Ms. Blue:

The American Iron and Steel Institute (AISI), on behalf of its U.S. member companies, who together account for approximately two-thirds of all the raw steel produced annually in the United States, is pleased to submit comments to the Trade Policy Staff Committee (TPSC) on the compliance of the People's Republic of China with its World Trade Organization (WTO) obligations, two years after China's entry into the WTO.

Summary. China, the world's largest steel producing and consuming nation, has the potential to be the most disruptive force in world trade in steel and many other products going forward. Therefore, the extent to which China is or is not playing fairly by the rules is of extreme importance to the U.S. steel industry. China must comply fully with all of its WTO commitments, end its unfair currency manipulation, eliminate its export incentive programs and other types of subsidies to steel and other "strategic" industries and open its market fully to imports of manufactures. At the same time, the United States and other WTO members must retain an unchallenged right to apply nonmarket economy antidumping methodology until steel and other key sectors of the economy in China are no longer under government regulation or control.

Prior to its accession to the WTO, China administered a complex and semitransparent system of licensing/registration, de facto import quotas and selective import tariffs to control steel imports. While the full extent to which China is now dismantling this system to conform to WTO rules is unclear, it is evident from recent reports that China is making significant moves to comply with its obligations, and that imports of steel products are increasing. At the same time, China continues to implement an array of market-distorting practices (such as subsidies and cartels) that do not necessarily contravene WTO rules, but which may require action in the future by the U.S. government pursuant to WTO-authorized trade remedies. Specific

information concerning these practices is set forth in Appendix 1. The flaws and weaknesses that characterize the WTO's dispute settlement system further diminish the prospect that China's market-distorting measures will be subject to effective discipline.

Quantitative restrictions. China administered a system of import quotas on steel products through the mid-1990s. While China contended thereafter that this system had been abolished, numerous reports continued to suggest that China was maintaining a de facto quota regime through the regulation of the issuance of import licenses.[1] In addition, in 2002, China imposed overt quotas on steel imports from three countries -- Kazakhstan, Ukraine and Belarus, with which China signed bilateral iron and steel agreements.[2] The terms of China's accession to the WTO included a commitment under GATT Article XI to abolish quantitative import restrictions. China reportedly eliminated such quantitative restrictions as may have existed as of late 2001/early 2002.[3] Chinese steel import quotas have been supposedly "eliminated" in the past -- while persisting in practice -- but the fact that China's steel imports have increased sharply in 2002 -- since the quotas were reportedly ended -- <u>may be</u> evidence that China might be adhering to this important WTO obligation.[4] Given the chequered history of Chinese import quotas in this sector, the U.S. should monitor China's implementation of its Article XI commitments to ensure that de facto quotas are not implemented through non-transparent administrative means.

Tariffs. China has reportedly reduced its import tariffs on steel by 2.5% in 2002, consistent with its WTO commitment.[5]

Trading rights. China has traditionally rationed "trading rights -- the authority to import and export steel products " -- to a relative handful of enterprises.[6] Some 75 percent of the product codes for which China agreed to liberalize trading rights in its accession agreement relate to steel.[7] China has committed to eliminate this system within three years of

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1 See Appendix 1, China's New Import Licensing Regime for Steel and "Chinese Import Curbs Hit Hot and Cold-Rolled Coil," *Metal Bulletin* (May 27, 1999).

2 See Appendix 1: China's Quantitative Restraints in Steel. "What Has 'WTO Accession' Brought to China's Manufacturing Sector?," Jingji Ribao, November 21, 2002; "Beijing Sources Say China Will Continue Restrictions on Steel Imports," World News Connection, September 4, 2002; "China to Give 5M Yuan Worth of Aid to Kazakhstan," BBC Monitoring International Reports, November 21, 2002; "China Imposes Quota on Ukrainian Steel," Interfax, May 22, 2002; "China, Ukraine Negotiating on Normalization of Steel Trade," Interfax, August 13, 2002; and "Russia Negotiates Quota Supply Steel to China," Interfax, August 8, 2002.

3 "Steel Exports Plunge As Imports Increase," China Internet Information Center, Business and Trade Section (April 17, 2002), <u>http://www.china.org.cn/english/BAT/30849.htm</u> (visited on 08/23/02).

4 Id., "China's Imports Skyrocket," *Taipei Times* (July 30, 2002).

5 "U.S. Steel Tariff Move May Cause Chain Reaction- Experts." *People's Daily* (March 21, 2002), <u>http://english.peopledaily.com.cn/200203/21/eng20020321_92514.shtml</u> (visited on 08/23/02)

6 One excellent summary of this complex system can be found in Ian Dickson's "China's Steel Imports: An Outline Of Recent Trade Barriers." Chinese Economy Research Unit, University of Adelaide (July 1996), pp. 8-10.

7 "Accession of the People's Republic of China: Decision of 10 November, 2001," WTO Doc. No.

accession.[8] Because limitations on trading rights constitute a significant market barrier, it will be important to monitor China's implementation of this commitment. So far, China's lack of progress in revising its trading rights regulations has been a point of contention during meetings between senior U.S. and Chinese trade officials, most recently in February 2003.[9] No English-language reporting since that time suggests that new firms have been granted trading rights to import steel.[10]

Application of safeguards. On May 20, 2002 China's Ministry of Foreign Trade and Economic Cooperation announced a safeguards investigation of certain steel imports and simultaneously imposed tariffs ranging from 7% to 26% effective as of May 24, 2002.[11] GATT Article XIX permits signatories to impose safeguard measures when increased imports are found to be a substantial cause of serious injury to a domestic industry. It is not clear that China's application of the provisional safeguard measures in this instance reflects a full investigation of the relationship between imports and the state of the domestic industry, given the fact that the notice of the investigation was published only 4 days before the tariffs became effective. The provisional tariffs were operative until November 20, 2002,[12] when definitive tariffs were implemented for five product categories until May 23, 2005.[13]

The importance of WTO-authorized trade measures. China is currently implementing a number of policies in the steel sector that, while not necessarily inconsistent with its WTO obligations, nevertheless distort the market and may result in injury to the U.S. steel industry. Traditionally, these measures have included massive subsidies provided through export and import substitution programs, state-orchestrated mergers, and debt-for-equity swaps.[14] Others forms of government support include the encouragement of output restraint cartels[15] and the rebate of a Value Added Tax in a manner designed to foster exports.

WT/L/432, (November 23, 2001),Annex 2B.

8 "Accession of the People's Republic of China: Decision of 10 November, 2001," WTO Doc. No. WT/L/432, (November 23, 2001), Annex 2B.

9 "U.S.-China Dialogue Produces No Immediate Results on Trade Irritants," Inside U.S. Trade, February 28, 2003.

10 The English-language search included English translations of Chinese news and government reporting, the MOFTEC website, a Dialogue search.

11 "Summary of Announcement No. 29 by MOFTEC." Iron and Steel Institute of Thailand. http://www.isit.or.th/announce_detail.asp?ContentID=499 (visited on 08/23/02). Note: the original MOFTEC notice is no longer available on the MOFTEC website, but is available on the ISIT's website.

12 Id.

13 "Notification Under Article 12.1 (B) of the Agreement on Safeguards on Finding a Serious Injury or Threat Thereof Caused by Increased Imports; Notification Pursuant to Article 12.1 (C) of the Agreement on Safeguards People's Republic of China," November 1, 2002 and "Announcement of the Ministry of Foreign Trade and Economic Cooperation on Applying Final Safeguard Measures to Some Imported Steel Products," Hong Kong Isinolaw, November 19, 2002.

14 See Appendix 1: China Subsidies in Steel for examples of this type of government support.

15 See Appendix 1: China Production Quotas in Steel for government-coordinated production.

Of particular concern this year is the fact that many -- at least 65 as of the end of 2002 -- Chinese steel companies remain under the de facto control of the Chinese government.[16] These state-owned-enterprises (SOE's) accounted for approximately 50 billion RMB (about $6 billion) in capital expansion expenditures in the Chinese steel industry in 2002, which continued to contribute to the steel industry's overcapacity.[17] Another area of concern is the Chinese government's intervention in the domestic price-setting mechanism.[18] MOFTEC reportedly called industry leaders together in March 2003 to encourage them not to increase prices on hot-rolled band and, in at least one case, mandated a price retraction. This ultimately led to a price collapse that affected China's export prices for that product.[19] Finally, low-interest-rate financing continues to be a concern in China's steel industry. Six industries were recently targeted to receive interest-rate subsidies, including steel, which was the largest recipient of the interest-rate subsidy.[20] Both private and state-owned steel companies continue to have access to low-cost funds from state-owned banks that have a strong incentive to lend to a "designated industry" such as steel.[21]

The Chinese government continues to promote exports of manufactures through tax forgiveness and other incentives, and to funnel massive government subsidies into targeted industries such as steel, which it deems to be "strategically important." In cases where such practices cause or threaten to cause injury to U.S. steel producers, the U.S. government should apply remedial measures authorized under the WTO. These include antidumping and countervailing duties and the anti-surge measures set forth in the terms of China's accession to the WTO.

Given its current nonmarket economy status for purposes of U.S. trade law, the Commerce Department at this time is not allowing Chinese subsidies to be offset pursuant to U.S. countervailing duty law. Until such time as Chinese subsidies are countervailable under U.S. trade law, the U.S. government must utilize the nonmarket economy provisions of U.S. antidumping law to offset such injurious effects as may occur from imports of Chinese steel into the U.S. market. In addition, resort to the anti-surge mechanism established under the terms of China's accession to the WTO may be necessary should U.S. trade remedies prove inadequate to offset fully the adverse effects of market-distorting practices in China.

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16 These state-owned-steel companies accounted for as much as 80 percent of China's pig iron output, 88 percent of its crude steel output, and some 78 percent of output other steel products during that year. "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 52.

17 "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 53.

18 "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 66, 89 and 91.

19 "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 66, 89 and 91.

20 "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 89 and 53.

21 "China's Unstoppable Steel Industry: Core Report DDDD," World Steel Dynamics, August 23, 2003 at 20, 29, 89 and 53.

Appendix 1

- **China's New Import Licensing Regime for Steel.** In February 2002, MOFTEC issued a new *Administrative Rule on Import Licensing of Goods* and *2002 Catalogue of Goods Subject to Import Licensing*, eliminating all but 12 product categories, including steel, from its conventional import licensing regime that maintains quotas and tariff-rate quotas.[22] Some 190 steel products are now subject to an "automatic licensing system" in which an import license is obtained, in theory, immediately upon application.[23]

  The stated intent of the automatic import licensing system is "to monitor the import of goods effectively," not to facilitate quotas.[24] Under the system, only designated operating enterprises are qualified to apply for, and obtain, the automatic import license.[25] If so qualified, an importer must file an application for the automatic import license to the MOFTEC-authorized issuing authority. The application package includes the application form, the importer's contract for the goods to be imported, the importer's corporate registration documents, supporting documents proving that the purpose of the final user of the imported item complies with Chinese law, and "other material" as required by MOFTEC.[26] The automatic license is supposed to be issued within 10 days of submission of the application.

  Notwithstanding the "automatic" nature of this licensing system, the State can adopt provisional measures to prohibit the import of goods subject to this automatic import procedure. Furthermore, for a select group of goods, including steel, two authorities--not one-- MOFTEC and the State and Economic Trade Commission[27] have jurisdiction over the automatic import license applications.[28]

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22 Commercial Information Circular No. 38/02, February 26, 2002. and BNA, February 28, 2002.

23 *Measures on the Control of Automatic Licensing for Import of Goods* and *MOFTEC Catalogue of Goods Subject to Automatic Import License Administration*, Text of PRC Measures on Control over Automatic Licensing for Import of Goods, Hong Kong Isinolaw, January 1, 2002, original sources, Beijing Guoji Shangbao, a daily newspaper sponsored by MOFTEC; MOFTEC Catalogue of Goods Subject to Automatic Import License Administration, Beijing Guoji Shangbao, January 6, 2002.

24 Text of PRC Measures on Control over Automatic Licensing for Import of Goods, Hong Kong Isinolaw, January 1, 2002, original sources, Beijing Guoji Shangbao, a daily newspaper sponsored by MOFTEC (Article 1).

25 Text of PRC Measures on Control over Automatic Licensing for Import of Goods, Hong Kong Isinolaw, January 1, 2002, original sources, Beijing Guoji Shangbao, a daily newspaper sponsored by MOFTEC (Article 9).

26 Text of PRC Measures on Control over Automatic Licensing for Import of Goods, Hong Kong Isinolaw, January 1, 2002, original sources, Beijing Guoji Shangbao, a daily newspaper sponsored by MOFTEC (Article 7).

27 The State Economic and Trade Commission (SETC) of the People's Republic of China is a component of the State Council pursuant to the Chinese cabinet institutional restructuring scheme passed in March 1998. As a macro-economic regulatory department, SETC's mandate is to regulate the near-term operations of the national economy. www.setc.gov.cn/index.htm.

28 Article 17, Text of PRC Measures on Control over Automatic Licensing for Import of Goods, Hong Kong Isinolaw, January 1, 2002. MOFTEC issued a separate set of rules for foreign invested enterprises (FIEs), *Detailed Implementing Rules for Administration of Automatic Import Licensing for Foreign-*

- **China's Quantitative Restraints in Steel.** When China imposed temporary safeguard measures on nine steel product categories beginning May 2002, it excluded Kazakhstan, Belarus, and Ukraine from its global safeguard measures because it had established with those countries bilateral steel trade agreements with "quantitative import limits."[29] According to PRC Customs Public Notice No. 9 of 2002, steel products imported to China from Kazakhstan, Belarus, and Ukraine "shall not exceed the country-specific quantitative limits and any excess portions shall temporarily be denied entry."

  Russia was included in China's temporary global safeguard measures implemented in May 2002.[30] However, Russia also appears to have taken on a hybrid safeguard and quota form. According to press reporting, at the same time China imposed tariff-rate quotas on Russia in conjunction with its global safeguard measures, China also imposed a quota separately from the tariff-rate quota.[31] Details about the amount of this quota or the products to which it applied are unknown at this time. Furthermore, as of November 20, 2002, China is reported to have imposed a quota on cold-rolled steel from Russia.[32] Details about it are scarce as well, but this quota has been described as "a special national quota" by the Russian press.[33] Agreement on it completed a protracted series of negotiations during which the Russian government and Russian steel-makers asked for quantitative restraints from China.[34]

- **China's Production Quotas in Steel.** China's State Economic and Trade Commission (SETC)[35] continued to manage domestic steel production and export in 2002. In February 2002, the SETC set a domestic production target of 125 million tons of steel for the year 2002.[36] Previously, in January 2002, the SETC had set a target of 7.5 million tons of steel exports for the year 2002.[37] This trend would appear set to continue in 2003, as Jia Yingeng, vice-director of the SETC's Bureau of Economic Operations, hosted a conference in November 2002 addressing the upcoming production targets and operational guidelines for China's steel industry in the year 2003.[38] Although specific volumes were

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Invested Enterprises in February 2002 and *Rules for Managing Automatic Imports by Foreign Funded Enterprises* in March 2002, but these do not appear to alter the regulations of the automatic licensing regime governing steel above. Beijing Zhonghua Renmin Gongheguo Duiwai Maoyi Jingji Hezuo Bu Wengao, March 12, 2002.

29 PRC General Administration of Customs Public Notice No. 9, 2002, Beijing Zhonghua Renmin Gongheguo Duiwai Maoyi Jingji Hesuo Bu Wengao, June 7, 2002 and Almaty Khabar Television, November 21, 2002. See also "China's Unstoppable Steel Industry," August 2003 at 83 for cold-rolled tonnage limits on imports from Ukraine, Russia, Kazakhstan, South Korea, Taiwan and Japan.

30 Eurasian Business Report, August 26, 2002.

31 Ros Business Consulting Database, August 23, 2002.

32 Russian Business Monitor, November 6, 2002 and November 22, 2002.

33 THE RUSSIAN BUSINESS MONITOR, November 6, 2002.

34 Interfax Business Report, August 8, 2002.

35 SETC has since been integrated into a newly created agency, the State-Asset Supervision and Management Commission.

36 Beijing China Daily, February 26, 2002.

37 Beijing China Daily, Internet Version, July 29, 2002.

38 The conference included leaders from SETC, the Ministry of Construction, the China Iron and

Exhibit 25

2003 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE

United States Trade Representative

2003 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE

December 11, 2003

United States Trade Representative

an economic toll, but also present a direct challenge to China's ability to regulate products that could have health and safety implications for China's population and international consumers. While a domestic Chinese business constituency is increasingly active in promoting IPR enforcement, piracy and counterfeiting remain pervasive. If significant improvements are to be achieved on this front, China will have to close legal and enforcement loopholes and devote considerable resources, political will and high-level attention to this problem.

The United States has had an ongoing dialogue with China on IPR matters for a number of years. In the Administration's view, keys to achieving effective IPR enforcement will be for China to lower thresholds for criminal prosecution, increase criminal penalties for IPR violators to deterrent levels, demonstrate a willingness to increase prosecution and punishment of IPR offenders, increase resources and devote more training for enforcement throughout China, and establish more effective communication procedures among relevant officials of China's courts and investigative units, the Supreme People's Procuratorate and China's lawmaking bodies.

In recent months, the Chinese leadership has signaled a new resolve to address IPR enforcement issues. In October 2003, Vice Premier Wu was appointed to head a Leading Group on IPR issues, which should help to reduce bureaucratic resistance and confusion on IPR enforcement among the numerous Chinese government entities with responsibilities in this area. In remarks following her appointment, she acknowledged China's IPR enforcement problem and explained that China was paying increasing attention to IPR enforcement, not just to implement its WTO commitments but also to attract more foreign investment as it opened up its market and to accelerate China's economic and social progress. She pledged that China would intensify its IPR enforcement efforts and penalize those who commit IPR infringement.

Services

Concerns continued to arise in many service sectors, principally due to transparency problems and China's use of capitalization and other requirements that exceed international norms. The United States and China have cooperated to resolve some of these concerns, but progress has been slow and uneven. Following bilateral discussions, China did begin to take steps to substantially reduce capitalization requirements in the insurance sector. In some cases, such as express delivery services, much progress was made toward resolving regulatory concerns in 2002, but problematic measures have re-surfaced in 2003 and remain under consideration. In other cases, such as China's implementation of its commitments on branching by insurance companies, the United States and China remain at odds despite a longstanding cooperative and otherwise productive dialogue with China's regulators.

Value-Added Tax Policies

China uses value-added tax (VAT) policies to encourage domestic production in a number of industrial and agricultural sectors. In the case of semiconductors, China's policy of providing VAT rebates to domestic semiconductor producers disadvantages U.S. exports and raises serious

WTO concerns. In the case of fertilizer, China exempts from the VAT fertilizer that is primarily produced domestically and that competes directly with the principal U.S. fertilizer export, another practice that raises serious WTO concerns. The Administration will continue to press China on these issues and will take further appropriate actions seeking elimination of China's differential tax treatment, including dispute resolution at the WTO, if necessary.

Transparency

An area of cross-cutting concern continues to be transparency. While some Chinese ministries and agencies have taken steps to improve opportunities for public comment on draft laws and regulations, and to provide appropriate WTO enquiry points, China's overall effort is plagued by uncertainty and a lack of uniformity. Some of China's ministries and agencies seek selective comment on proposed regulations and implementing rules from domestic Chinese interests, while excluding participation from foreign businesses active in the China market. The Administration is committed to seeking improvements in this area.

Trading Rights and Distribution Services

Ensuring the unrestricted rights of all Chinese and foreign businesses to engage in importing and exporting was a key WTO accession commitment obtained by the United States and other WTO members, as was China's commitment to fully liberalize the distribution services sector. To date, however, China has fallen behind in its implementation of these commitments, which are required to be phased in over the first three years of China's WTO membership. Foreign businesses, in particular, continue to be beset by a variety of restrictions, which are undercutting market access for the entire range of U.S. businesses active in the China market. With full liberalization in these important areas required by December 11, 2004, Administration officials are actively engaged with their Chinese counterparts in an effort to obtain China's full compliance.

Conclusion

As this year's Report reveals, while the U.S.-China economic and trade relationship is growing rapidly, there are a number of systemic concerns that remain, making further improvements in that relationship problematic. The Administration remains committed to resolving the United States' concerns through all available means. The Administration's preference is to resolve those concerns through bilateral consultations in a timely and effective manner. If bilateral efforts are not successful, however, the Administration is fully prepared to enforce U.S. rights through other means, including dispute resolution at the WTO.

Prior to the adoption of an automatic trading rights system, China committed that it would no longer condition eligibility for trading rights on export performance, trade balancing, foreign exchange balancing or prior experience requirements. This commitment took effect immediately upon China's accession (on December 11, 2001). China further committed to expand the availability of trading rights pursuant to an agreed schedule covering the first three years of its WTO membership. First, China committed that it would make trading rights available to Chinese enterprises immediately upon its accession, subject to certain minimum registered capital requirements, to be gradually decreased during the three-year transition period (ending December 11, 2004). The minimum registered capital was to be set at RMB 5 million ($603,000) on December 11, 2001, and then reduced to RMB 3 million ($362,000) one year later (December 11, 2002) and to RMB 1 million ($120,600) two years later (December 11, 2003) before being eliminated three years later (December 11, 2004). Second, China committed that it would make full trading rights available to joint ventures with minority foreign ownership beginning not later than one year after China's accession (or by December 11, 2002), except with regard to those goods still reserved for state trading under China's accession agreement. Third, China committed that it would make these same trading rights available to joint ventures with majority foreign ownership beginning no later than two years after China's accession (or by December 11, 2003).

To date, it appears that China has fully implemented its trading rights commitments insofar as they relate to Chinese enterprises. With the issuance of the *Circular Concerning the Rules on the Administration of Import and Export Rights* in July 2001, and the issuance of the *Notice on the Rectification of Import and Export Qualification Standards and Verification Procedures* in August 2003, China has kept pace with the required reductions in the minimum registered capital requirement for Chinese enterprises to obtain trading rights. Currently, the minimum registered capital for Chinese manufacturing enterprises is RMB 0.5 million ($60,300), and the minimum registered capital for Chinese trading enterprises is RMB 1 million, except in the central and western regions, where the requirement was RMB 0.5 million.

Meanwhile, it appears that China has fallen behind in implementing its trading rights commitments insofar as they relate to foreign-invested enterprises. China has not made full trading rights available to all joint ventures with minority foreign ownership (as was required by December 11, 2002), nor has China yet even issued provisions allowing for full trading rights to be available to all joint ventures with majority foreign ownership (as is required by December 11, 2003). Instead, China has continued to limit the availability of trading rights by imposing conditions on the eligibility of these enterprises, including requirements related to minimum registered capital, import levels, export levels and prior experience, as a review of China's measures in this area shows.

Since well before China's accession, pursuant to China's *Foreign Trade Law*, foreign-invested manufacturing enterprises have had the right to import inputs for production purposes and the right to export their finished goods, without the need for prior approval. In January 2001, China expanded the import rights of some foreign-invested manufacturing enterprises with the issuance

of the *Supplementary Provisions (II) to the Provisional Regulations Governing the Establishment of Investment-type Companies by Foreign Business Investment.* In July 2001, shortly before its accession, China granted limited additional export rights to some foreign-invested manufacturing enterprises with the issuance of the *Circular Concerning the Extension of Import and Export Rights for Foreign-Funded Enterprises.* Both of these measures, however, conditioned trading rights eligibility on requirements related to minimum registered capital, import levels, export levels and/or prior experience, among others.

China's treatment of foreign-invested enterprises seeking to operate as trading companies is set forth in the January 2003 *Provisional Rules for the Establishment of Chinese-Foreign Equity Joint Venture Foreign Trade Companies.* The new rules permit the formation of foreign-invested trading enterprises (with minority foreign ownership immediately and majority foreign ownership after December 11, 2003), which may import and export all goods (except goods reserved for state trading), but only if certain stringent requirements are met. For example, the foreign investor must have had an average annual amount of trade with China of at least $30 million for the preceding three years (or $20 million if the foreign-invested trading enterprise registers in the central or western regions of China). Similar requirements apply to the Chinese investor. In addition, the foreign-invested trading enterprise must have minimum registered capital of RMB 50 million ($6.03 million) and personnel experienced in conducting international trade.

The United States raised its concerns with China's restrictive treatment of foreign-invested enterprises in bilateral meetings throughout 2003, beginning with the Trade Dialogue meeting held in Beijing in February and including a series of high-level meetings later in the year and a second Trade Dialogue meeting in November. The United States urged China to take immediate steps to bring its regulations into compliance with its trading rights commitments. The United States and several other WTO members also raised these same concerns during the transitional review held by the WTO's Market Access Committee in October 2003.

During these same meetings, the United States pressed China on the importance of issuing, in a timely manner, final laws and regulations creating an automatic trading rights system for all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships. These laws and regulations must be implemented by December 11, 2004, and MOFCOM reported that it is in the process of drafting relevant amendments to the *Foreign Trade Law.* The United States also urged China to adhere to its obligation to provide the opportunity for public comment on drafts of these laws and regulations, and China indicated that it would do so well in advance of the December 11, 2004 deadline.

In a positive development, in November 2003, China announced that it had authorized the granting of trading rights to certain U.S. auto companies, one year ahead of the schedule to which it had committed in its accession agreement. These companies will be able to import sizeable quantities of U.S.-produced motor vehicles into China and, as discussed below in the Distribution Services section, establish their own exclusive networks to sell and service those vehicles in China.

Exhibit 26

Chinese premier to hear string of EU trade complaints in Brussels today

By Tobias Buck in Brussels

Chinese prime ministers have grown accustomed to being ticked off by European Union leaders over human rights.

Yet Wen Jiabao, who is to meet the European Commission in Brussels today, is likely to find the EU almost as upset over something else – China's shaky commitment to international trade rules.

This might come as a surprise to Mr Wen and Bo Xilai, the Chinese trade minister who is also in Brussels today. Since China joined the World Trade Organisation three years ago, European trade officials have always been careful to avoid the shrill tones often heard from their counterparts in Washington.

But despite reassurances that the Commission, in the words of one of its officials, still prefers "quiet diplomacy", today's meeting will see Pascal Lamy, the trade commissioner, launch a string of complaints.

On top of the tough words Mr Wen can expect on China's trade policies, he will also be told that there is little chance he will be granted the two trade concessions China has been seeking most urgently from the EU: the lifting of the EU arms embargo and the EU's official recognition of China as a market economy. The latter concession is important to China because it would make it harder for the EU to punish Chinese producers for dumping.

But while both concessions would hand tangible benefits to China, European trade officials argue that Beijing is motivated just as much by political symbolism. China, they say, is desperate to destroy the remnants of the pariah status it gained after the Tiananmen Square massacre in 1989.

"Much is about political symbolism," one official said. "The stamp of respectability matters enormously."

The Commission will be able to make a preliminary judgment on China's market economy status in June but so far it seems unlikely that Beijing can meet all the EU criteria.

Wen Jiabao: little chance of winning trade concessions

The EU meanwhile wants China to give European companies better access to the Chinese market and to end what Brussels sees as breaches of international trade rules. Officials say that Mr Lamy will make it clear that one or the other complaint could soon end up before a WTO panel – a step China is keen to avoid.

The Commission is particularly concerned about two recent developments – China's reluctance to revoke restrictions on the export of coking coke, a raw material for steelmakers, and the hurdles faced by foreign construction companies seeking to enter the Chinese market.

"These are the two hot issues where we want to see movement," a Commission official said. He added that, looking to the future, the EU also had concerns over restrictions faced by European car companies.

The tougher line adopted by Brussels reflects in part the pressure that a number of European industries such as textiles manufacturers have brought to bear on the Commission.

William Lakin, the director general of the European textiles association Euratex, says his industry has long suffered from the "inexplicably" low prices of goods coming from China, and wants the EU to take a hard line.

However, many European companies are also urging restraint. "The majority of businesses are quite happy with the way things are going in China," said Peter Nightingale, chairman of the Euro-China Business Association.

■ The EU is unlikely to lift its arms embargo until at least the end of the year, **Judy Dempsey reports from Dublin.**

The continued opposition to lifting it shows a hardening of policy by several member states since France first raised the issue at last autumn's EU summit.

Ireland, which holds the EU's rotating presidency until the end of June and which takes a tough line on human rights, says it does not expect to lift the embargo under its tenure and the US has stepped up pressure on other member states to block French moves.

France, like Germany and Italy, argues it is time to review the embargo given China's improving human rights record.

Britain, the Netherlands and others say Beijing's latest attempts to curb Hong Kong's aspirations for fuller democracy have confirmed their opposition.

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CORRIGENDUM

In the Tender Notice No.1/2004-2005 dated 21.04.04 issued for the construction of New Secretariat Complex at Chennai, Tamil Nadu, India the word "firms" wherever appears stands deleted.

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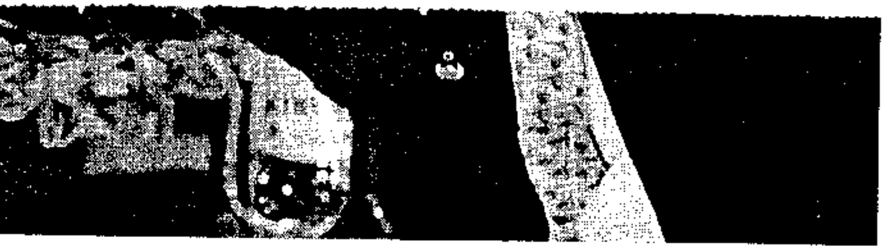

had a palm tree that came in like a missile," says Ruben Rodriguez, chairman, whose Bermuda home was also affected.

It was fortunate for Mr Rodriguez that Bacardi's global headquarters in Hamilton, the Bermudian capital, were unscathed.

they the only Bacardi possessions that might stand out on the balance sheet of a publicly-listed enterprise.

Few will know that the distiller jointly owns a tanker that ships rum in bulk between the Caribbean and Europe, in defiance of the trend to contract out

bid jointly with Brown-Forman, the maker of Jack Daniel's whiskey, but they were beaten by a pairing of Diageo and Pernod Ricard.

Mr Rodriguez blames a lack of financial flexibility for the defeat. His successful attempt to secure for directors the power to issue

Exhibit 27

from the publishers of Inside U.S. Trade

Inside US-China Trade

the exclusive weekly news service of ChinaTradeExtra.com

Vol. 4, No. 19 - May 12, 2004

BYRD PRESSES CUSTOMS FOR SOLUTIONS TO CHINA DUMPING DUTY COLLECTION PROBLEM

Sen. Robert Byrd (D-WV) last week asked Customs and Border Protection Commissioner Robert Bonner to provide details on why CBP failed last year to collect about 40 percent of the antidumping duties it was charged with collecting, including more than $105 million in duties on Chinese imports such as crawfish, honey, garlic and other products. In a May 4 letter to Bonner, Byrd warned that the failure of CBP to address this problem would continue to undermine U.S. trade remedy laws and do further harm to industries that rely on these laws to guard against dumped imports.

"I am greatly concerned that the continuation of these problems with duty collection will enable Chinese imports to quickly destroy vulnerable sectors of the U.S. economy that our antidumping laws are designed to protect from unfair trade practices," Byrd wrote.

Byrd's letter reiterated longstanding complaints from U.S. petitioning industries that under U.S. law, new Chinese shippers are allowed to export products to the U.S. if importers post bonds that cover the antidumping duty, as opposed to cash deposits. In addition, Byrd said he has been informed that CBP is not obtaining single-entry bonds for these imports, which are bonds covering a single shipment, and instead is permitting several shipments under a continuous entry bond. This allows Chinese exporters to export a large volume of goods into the U.S. without the requirement that U.S. importers pay the bulk of the duties owed up front, despite a 1985 agreement

continued on page 7

TALKS ON MARKET ECONOMY STATUS SEEN AS U.S. SHIFT AWAY FROM CHINA'S WTO ACCESSION DEAL

The decision by the Bush Administration to launch a series of discussions on what steps China would need to take in order for the U.S. to consider it a market economy in trade remedy cases is being seen by informed observers as a calculated step by the U.S. away from the terms of China's entry into the World Trade Organization.

These sources said the dialogue itself can be read as a signal that the Bush Administration is keen to give China market economy status, and at the very least indicates that the administration is willing to negotiate with China on its status, since it clearly shifts the burden of demonstrating that China is a market economy away from China to affected U.S. industries.

According to China's protocol of accession to the WTO, members are permitted to treat China as a non-market economy for the first 15 years of China's membership. It also includes language that says market economy status can be granted earlier if China demonstrates it has met this hurdle.

"[S]hould China establish, pursuant to the national law of the importing WTO Member, that market economy conditions prevail in a particular industry or sector, the non-market economy provisions of subparagraph (a) shall no longer apply to that industry or sector," the protocol says, referring to language allowing the treatment of China as an NME.

However, with the April 21 announcement of a new bilateral dialogue dealing with China's request for market-economy status, the burden of proof has been lifted from China, as the U.S. has effectively agreed to negotiate with China on its economic status. This shift is adding to speculation that the administration is looking to designate China as a market economy, a possibility that is already prompting some fears within U.S. industry groups that a key

continued on page 4

INDUSTRY MULLS NEW OPTIONS IN CURRENCY FIGHT AFTER U.S. REJECTS SECTION 301

U.S. industry groups seeking to keep pressure on China to revalue or float the renminbi are considering other steps to achieve this goal in light of the Bush Administration's April 28 announcement that it would reject a Section 301 petition, if these groups were to file it. That announcement prompted supporters to hold off on filing a petition that calls for an investigation into how China's policy of pegging the renminbi at 8.28 to the dollar creates an unfair trade advantage for U.S. companies.

National Association of Manufacturers Vice President for International Economic Relations Frank Vargo said another possible option would be to file countervailing duty cases against China that argue its non-performing loans or policy of keeping the value of the renminbi artificially low act as subsidies that should be countered with duties. Vargo said there is a "growing interest" in this option, and that he "wouldn't be surprised" if such a case were filed in the future.

The second option is to seek to lower the threshold set in U.S. trade law for Treasury to determine that a foreign country is manipulating its currency to gain an unfair trade advantage.

continued on page 5

and that this step must take place first before broader issues, such as a possible FTA, are discussed.

Regarding the specific issues being raised by the U.S., Freeman was sharply critical of Taiwan's performance on IPR enforcement, and said it is very difficult to find something new to say about all four outstanding trade issues. On IPR, Freeman said the Bush Administration would prefer to take Taiwan off the priority watch list on IPR enforcement, but said it would be difficult to do so given the absence of any concrete steps from Taiwan, and given past placement by the U.S. as a priority country

"Taiwan is too advanced, too mature an economy to be on the priority watch list," Freeman said, adding that IPR problems in Taiwan are "absolutely rampant." He added that most industry groups put China first on the list of countries where IPR enforcement is seriously lacking, and place Taiwan second, followed by every other country, and said it is "absolutely scandalous" and "absolutely unacceptable" that China and Taiwan are at all comparable on IPR enforcement given the level of Taiwan's development.

To remedy the problem, the U.S. needs to see additional legislation from Taiwan that will address remaining U.S. complaints about piracy, Freeman said. The U.S. last year complained that legislation presented by the administration of President Chen Shui-bian was a promising start to improved enforcement, but was ultimately derailed by Taiwan's Legislative Yuan. Among other things, the Legislative Yuan added language that nullified efforts to classify copyright piracy as a public offense, and required authorities to witness piracy before they can bring criminal complaints.

The law also eliminated language prescribing minimum jail terms and fines in criminal IPR cases, and allows some pirated works to be made without considering such production a crime (*Inside US-China Trade*, July 2).

On agriculture, the U.S. has asked Taiwan to expand market access for rice beyond its original World Trade Organization commitments. The U.S. has also complained that Taiwan has created an incentive for its hospitals to use generic drugs, and has placed more expensive research-based drugs at a disadvantage in that market.

Freeman last week also noted that Taiwan tried unsuccessfully to join WTO consultations with the U.S., European Union, Japan and Mexico in a case against the value added tax (VAT) that China imposes on foreign made and designed semiconductors. The first round of WTO consultations took place on April 27, but China rejected Taiwan's request to join them because Taiwanese officials referred to themselves as members of Taiwan's permanent mission to the WTO.

This fight is a continuation of one that has gone on since China and Taiwan joined the WTO, and has seen China balk at dealing with Taiwan until Taiwan refers to itself in terms that do not hint at or otherwise denote sovereignty.

Freeman said this ongoing dispute is a source of "great frustration" for the U.S. government, which believes both sides need to shelve these political differences and limit discussions in the WTO to those relating to trade issues. He said the U.S. wishes that "both sides would grow up."

EU WARNS OF POSSIBLE WTO CASE ON CHINESE COKE EXPORT RULES

European Union officials late last week warned China that it would consider launching its first World Trade Organization challenge of its policies unless China eases its export restraints on coke, a fuel derived from coal needed to make iron and steel. European sources confirmed this week that the European Commission gave China until the end of this week to take steps to resolve this issue, or the EU would consider asking for consultations under the WTO's Dispute Settlement Understanding.

Specifically, the EU is looking for "satisfactory answers" from China this week on how China proposes to amend its export licensing system for coke so the system treats foreign producers fairly, one European industry source said. In addition, the EU wants China to agree to grant extra export licenses so European producers are able to obtain an adequate supply of coke, this source said.

The issue was raised by the Commission when Chinese Premier Wen Jiabao visited Brussels on May 5 & 6, according to informed sources.

European industry and government sources reached this week had few other details about the specifics of the EU complaint, and were unclear what specific violations of WTO rules that the EU might allege in a request for consultations under the DSU. However, such a request is an action that U.S. companies have called on the Bush Administration to consider in light of how China's harsh restrictions on coke exports are affecting U.S. producers. The National Association of Manufacturers in March called on U.S. Trade Representative Robert Zoellick and Commerce Secretary Don Evans to give "serious consideration" to filing a WTO case against countries that impose such export restraints.

While NAM's March 23 letter did not specifically mention China, sources said it was aimed at China, Egypt, India and others that maintain export restrictions. China in particular maintains a quota on coke exports, offers a lower value-added tax rebate on coke exports, and has imposed high licensing fees on over-quota exports.

NAM said in March that China has yet to offer any evidence that its coke export restraints are justified under Article XI of the General Agreement on Tariffs and Trade, which prohibits restrictions on exports except under

Exhibit 28

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Steel

BUSINESS INTELLIGENCE FOR THE STEEL INDUSTRY

CRUspi futures Q3* -2.1%

WEEK ENDING: 7 May 2004 — *On previous quarter

CRUspi	Value	Wk on Wk	Mth on Mth	Year on Year
Global	149.1	0.1%	2.2%	54.3%
Flats	140.2	0.0%	-0.7%	46.9%
Longs	166.8	0.3%	7.7%	68.8%
North America	146.6	0.0%	4.9%	85.3%
Europe	139.1	0.4%	9.7%	32.3%
Asia	156.0	0.0%	-2.4%	52.7%

www.cruspifutures.com Full report page 12

■ STEELMAKING ■ STOCKHOLDING ■ FINANCE ■ TRADE ■ MARKETS ■ SCRAP ■ INVESTMENTS ■ PEOPLE ■

Arcelor to invest €500m in Spain page 2

Arcelor plans to make €500m of investments, coupled with major cost savings, in a restructuring of its Asturian operations, northern Spain.

ISG signs deal to buy Georgetown Steel page 2

International Steel Group continues with its aim of consolidating the US industry with an agreement to buy Georgetown's DRI and wire rod mill.

Salzgitter to cut slab purchases by 70% page 3

Germany's Salzgitter expects to reduce its external slab purchases to a maximum of 200,000t/y once its third BF comes starts up in December.

Supply constraints threaten growth page 3

Raw material supply constraints could hamper growth in global steel consumption, according to the International Iron and Steel Institute.

Scrap prices drop as supply improves page 10

West European scrap prices continue to fall, as reduced Chinese demand for scrap and steel products depresses the international market.

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3 Deliveries go on despite strike at **Sidor**
4 Creditors and **Weirton** reach deal
4 Pick up in **Cosipa's** shipbuilders' orders
4 **LNM** plans South African pricing policy
5 Call for **Vietnam** to reinstate duties
5 **Beijing** moves to halt illegal projects
5 **China** wooed by **IISI**
5 Further energy use cuts by **US mills**
6 **Corus** to raise organic coated prices
6 **Arcelor/Severstal** eye **Krivorozhstal**
6 **Kurum** halts Albanian production
6 Rolling as normal after fire at **OneSteel**
7 More price hikes in **US**
8 **JPSL** to finish $122m of projects early
8 Higher prices boost **US scrap** production
8 **Ispat International** doubles income
8 **Tenaris'** profit up 6.3% as sales improve
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during 2003/4, compared with 62% in 2002/3. The domestic industry has always been a priority for us and the ISA has never exported at the cost of the domestic industry," he added.

Vietnam's mills call for reinstatement of tariffs

Vietnam's steel sector association VSA has made a fresh call on Hanoi to reinstate duties on finished steel products' imports as they are affecting the domestic industry's performance. The increased supply was adding to its burdens at a time of rising raw material and energy costs, VSA's vice chairman Pham Chi Cuong told *SteelWEEK*. The association has urged the government to reapply the 10% import duty on steel from mills in the Asean trading block, and 20% from all other countries. The exception is billets: VSA members have agreed to a zero import tariff on the semi-finished product. Hanoi removed levies on 1 March to ease supply problems as Vietnam (population: 82m), which is going through a construction boom, is experiencing one of the largest regional growths in steel demand.

Beijing moves to halt illegal projects

Beijing has moved to carry out its threat to halt illegal steel projects in a bid to avert an overheating of the economy (*SW 30 April 2004*). It has emerged central government ordered a stop on the 8.4mt/y, Yuan 10.59bn ($1bn) **Jiangsu Tieben** steel mill being built in Changzhou city, Jiangsu province, east China. Beijing is also punishing the local officials who approved the illegal steel project, construction of which started in June 2003. The entrepreneurs behind Jiangsu Tieben formed seven companies, including joint ventures, and divided the development into 22 separate projects. The seven companies then individually submitted the 22 small projects to local government to gain permission, by-passing rules which state large projects, such as an 8.4mt/y steel mill, must receive permission from Beijing. The local government's go-ahead also allowed Jiangsu Tieben to obtain the land and financial support necessary to press ahead with its plans, but without central government's required license. Regional media reported more than Changzhou 4,000 residents were forced to move home to enable construction.

IISI steps up woo China

The Brussels-based International Iron and Steel Institute (IISI) is to step up efforts to persuade China to join the organisation by offering incentives. These include holding the IISI's Q2 meeting in the country next year provided China joins the institute before the general meeting in Istanbul, Turkey, this October, said South Korea's **Posco**, which led a wide range of discussions on China and the global steel industry's prospects at an IISI board meeting in Rio de Janeiro, Brazil. The institute also plans a study on the country's growing steel industry, called *China 2010*, and an analysis of scrap's demand/supply prospects.

■ Posco president Chang-Oh Kang has called for expansion of cooperation between the South Korean and Chinese steel industries. Speaking at last week's 2nd Annual Symposium on South Korea-China in the Economic Integration of East Asia, in Seoul, Kang said: "Efforts must be made in terms of strategic cooperation for raw and subsidiary materials."

AK Steel settles Wardrop dispute

AK Steel says it has settled a dispute with its former chairman and CEO Richard Wardrop by paying "significantly less" than the $51m-plus he claimed for severance and retirement pay following termination of his employment from the company last September. Ohio-based AK Steel, which contested the claim, did not give the settlement figure in its report to New York's SEC.

US mills go on reducing energy use

US mills have reduced energy use, and greenhouse gas emissions, by 17% since 1990 through recycling and process innovation, according to the latest progress report to the Department of Energy (DOE). "The steel industry has a standing commitment to sustainability backed by significant investment in new technologies to improve energy efficiency, reduce carbon emissions and heighten productivity," said David Sutherland, chairman of the American Iron and Steel Institute (AISI) at its annual meeting in California. The industry is targeting a further 10% saving in energy use by 2012, using a 2002 baseline of 14m BTU/s.ton shipped. "To achieve this ambitious goal will be extremely difficult. We believe it is possible, but we have to broaden and accelerate our research into new technologies," he said.

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Exhibit 29

EMERGING ECONOMIES TRANSITION

China in the Global Economy

Reforming China's Enterprises

ECONOMICS

OECD

Box VI.1. The role of the financial system in promoting industry re-organisation

Financial facilities to facilitate M&A and other re-organisation are still quite limited in China. As indicated in Chapters III and IV, mergers, acquisitions, and other forms of reorganisation are largely initiated and controlled by government agencies. Certain of the asset management and holding companies, such as the Wuhan Asset Management Company described in Chapter V, have begun to promote mergers and acquisitions with enterprises outside their own group, but their activities are still quite limited. The stock markets have served as a catalyst for mergers and acquisitions – nearly 200 occurred among companies listed on the Shanghai Exchange in 1998 alone – but the impact is limited by the narrow segment of institutions that are listed. Further development of the stock markets and increase in the number and range of listed companies should provide a foundation for market based reorganisations as well as help to break down the still considerable barriers to mobility of enterprise operations across provincial boundaries. However more will be needed, including: completion of the corporatisation process so that equity stakes can be transferred; clarification of enterprises' ability to dispose of their assets; and development of investment banking facilities to provide financing and technical advice for business reorganisations.

The recent establishment of the bank asset management (BAMC) companies[1] to work out the NPL of the commercial banks potentially represents an important development in the financial system's role in enterprise restructuring. The key mandate of the BAMC is to maximise recovery value of the assets acquired from the banks.[2] While the scope of their operations remains to be clarified, initial indications after the formation of the first BAMC, Cinda Asset Management Company for the China Construction Bank, suggested that the companies would have considerable flexibility and a range of instruments in dealing with non-performing loans. These include: reorganisation and management changes of indebted enterprises, facilitation of mergers and acquisitions, debt-equity swaps, and resort to bankruptcy in cases of economically unsalvageable operations. The legal and administrative claims derived from the holding of enterprise debt, combined with the backing of central government authorities, potentially give the BAMC considerable leverage to promote restructuring and overcome administrative barriers to its accomplishment.

The initial operations of the BAMC in the latter half of 1999 focused on debt-equity swaps with larger SOE (see Chapter III). The operations have been carried out by the BAMC holding the debt together with the original bank creditor(s) and the enterprise or enterprise group itself. The debt-equity swap agreements have been linked to reforms mandated by the Company Law (in particular establishment of boards of directors and boards of supervisors) as well as reorganisation of operations.[3] However, major changes of enterprise senior management do not seem to have occurred, or at least have not been publicly announced. The agreements also do not seem to have imposed specific ongoing conditions on future performance or implementation of reforms. A provision in the agreements allows the BAMC to sell back the equity to the enterprise after several years if the BAMC would otherwise make a loss, but the degree to which this provision provides any effective conditionality remains to be seen. There is thus a concern that the program is seen as a "free lunch" by enterprises that does little to increase their incentives to improve their operations.

The broader effectiveness of debt-equity swaps in facilitating enterprise restructuring and in maximising the recovery value of BAMC assets remains to be seen. Economically successful reorganisations can involve concerted efforts over time. As holders of fixed income claims that need to be restructured, BAMC in principle have an ongoing influence on the restructuring process. By swapping the debt for equity, the BAMC gain a voice in selecting directors and senior management and in setting the strategic direction of enterprise operations. In practice, this influence is shared with other equity holders, with state asset management companies or government agencies retaining the controlling interest, at least in the case of larger SOE. The influence of the BAMC as equity holder is further limited given that formal claims and powers of minority equity holders in China are, if anything, weaker and less easily enforced than those of holders of fixed income claims. Continued holding of debt or other means may be most effective way for BAMC to promote successful restructuring in some circumstances, while debt-equity swaps are more effective in others. Thus BAMC are likely to need to retain flexibility in their instruments if they are to fulfil their mandate.

1. The four companies are: Cinda AMC (China Construction Bank), established in April 1999; Orient AMC (Bank of China); Huranga AMC (Industrial and Commercial Bank of China); and Great Wall AMC (Agricultural Bank of China). The latter three were established in November 1999. Together the four AMC are due to take on non-performing loans equal to 1.2 trillion yuan, or about 18 per cent of the total loans of these banks to the corporate sector.
2. According to an article published by the Xinhua News Agency (4 November 1999), business activities of the Cinda AMC will involve "... purchasing and performing trust management for non-performing loans accumulated by commercial banks; debt retrieval and restructuring; investment consulting; borrowing from financial institutions and applying to the central bank for re-lending funds; issuing bonds; direct investments; and various activities involving other sectors ...." The article also notes that BAMC are authorised in principle to sell debt to overseas investors.
3. A series of well-publicised debt-equity swaps were announced during the second half of 1999 involving large SOE in a range of industries. Indicative examples are agreements signed with Anshan Iron and Steel (Liaoning Province) and Baosteel Group (Shanghai) in November of 1999. These deals, in which all four BAMC were parties, involve substantial reductions in debt loads in return for restructuring arrangements whose details have not been fully revealed.

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Table VI.2. **Sources of corporate funds**

	1995		1998	
	Value (billion yuan)	Share (per cent)	Value (billion yuan)	Share (per cent)
Total external funds raised	1 152	100	1 395	100
Loans from financial institutions	1 014	88.0	1 152	82.6
Funds raised from markets	138	12.0	243	17.4
Bonds	22	1.9	15	1.1
Equity	15	1.3	84	6.0
Commercial bills	101	8.8	144	10.3

Source: *China Financial Outlook*, 1999, p. 57.

... and remain state owned

Three related features of China's financial system are distinctive and have important implications for the development of the enterprise sectors. First, virtually all domestic financial institutions are state-owned. Unlike European transition economies, which moved to privatise their banks and other financial institutions at a fairly early stage (OECD, 1997*b*), presently there are no plans in China to relinquish state ownership of existing financial institutions, although entry of new private institutions is encouraged in principal.

Concentration is exceptionally high

The second distinctive feature is the overwhelming dominance of the four major state-owned commercial banks in credit allocation. These institutions account for 90 per cent of loans provided by the banking system, and nearly three-quarters of total loans to business (Table VI.3). This concentration is very high compared to most other developing and transition economies and well above the concentration ratio normally considered to be compatible with adequate competition.[86]

Table VI.3. **Lending by major classes of financial institutions**
As of end-1998

	Total loans (billion yuan)	Percentage of total	Loans to non-financial sectors (billion yuan)	Percentage of total
Total	8 964.7	100	8 149.3	100
4 major state commercial banks	6 782.5	75.6	6 231.4	76.4
Other commercial banks	655.5	7.3	531.4	6.5
Rural credit co-operatives	953.4	10.6	881.4	10.8
Urban credit co-operatives	462.2	5.1	400.8	4.9
Trust and investment companies	111.1	1.4	104.3	1.3

Source: *The People's Bank of China Quarterly Statistical Bulletin*, various issues.

... as is the focus on lending to SOE

The third distinctive feature is the concentration of financing on SOE. Although the share has declined in recent years, at least 80 per cent of the loans of the major state banks, and nearly 75 per cent of all commercial bank loans, are directed to SOE, while less than 10 per cent go to non-state enterprises.[87] SOE also typically enjoy preferred access to equity and bond market financing. The gap between the SOE share of commercial bank lending (and overall credit raised externally) and their share of output has increased substantially

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Exhibit 30

Backgrounder

No. 1698
October 23, 2003
Published by The Heritage Foundation

The U.S. Must Face Up to China's Trade Challenges

John J. Tkacik, Jr.

China has been a member of the World Trade Organization (WTO) for almost two years, but is still dragging its heels on fulfilling its WTO commitments. If it were a smaller economy, some of China's transgressions could be tolerated, but when the world's fourth largest trading nation ignores its obligations, China's trading partners ought to act.

One thing is clear: China will not change its behavior unless it faces credible prospects of retaliation. Therefore, persuading China to comply with its WTO obligations will take a combination of economic leverage and diplomatic pressure.

The U.S. Response

Aside from the panoply of retaliatory tariffs contemplated under various sections of the 1974 Trade Act, there are other and more effective pressure points that could be used. Specifically, the Administration should begin now to:

- **Direct** the U.S. Trade Representative to prepare a formal complaint against China at the WTO,
- **Review** technology export controls and reassess their impact on U.S. defense preparedness, and
- **Rigorously review and enforce** controls on Chinese technicians seeking to work on advanced scientific and technological projects in the United States.

Some believe that the threat of punitive tariffs on Chinese goods (for instance, under Section 301 of the Trade Act) has been an effective lever on Chinese behavior in the past, and this is a view generally

- With the Chinese market for imported soybeans valued at $2 billion annually, Beijing's temporizing cost U.S. farmers at least $112 million in 2002.
- Beijing wants to force foreign firms to set up billion-dollar semiconductor "fabs" inside China to support its defense technology sector.
- "[D]espite China's commitments to cracking down on rampant piracy, fake CDs, DVDs and pharmaceuticals continue to flood the market, costing us [an] estimated $20-25 billion annually."
- U.S. companies acknowledge that their Chinese joint venture partners and the Chinese government siphon off proprietary technology, trade secrets, and intellectual property, but they are reluctant to pursue the issue for fear that it will affect their business standing in China.
- The apparent undervaluation of China's currency appears to be an outgrowth of China's insistence on restricting the outflow of capital, but destabilizing China's currency would not reduce America's problems.

This paper, in its entirety, can be found at:
www.heritage.org/tradeandforeignaid/bg1698.cfm

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ment siphon off proprietary technology, trade secrets, and intellectual property, but they are reluctant to pursue the issue for fear that it will negatively affect their business standing in China. Apparently, the Chinese government's preferred way of gaining access to U.S. advanced technology is via human sources, particularly students and technicians from U.S.–Chinese joint ventures in China who want to work in advanced-technology laboratories and production facilities in the United States.[25]

Nor are American high-tech firms China's only victims. In March 2002, Taiwan Semiconductor Manufacturing Company (TSMC) accused a former manager of stealing information on its 12-inch wafer fabrication technology.[26] Later, TSMC discovered that documentation for its entire eight-inch waferfab production line had been posted on-line without authorization with Taiwan's National Chiao-tung University library and that another employee had downloaded and copied it.[27]

In March 2003, in a comprehensive report on China's WTO compliance, Japan's Ministry of Economy, Trade and Industry (METI) commented that "intellectual property rights infringements, including counterfeiting and piracy, have long been a serious problem in China" and observed that the Beijing government has "taken steps to deal with the problems, but little improvement has been seen." The METI report pointed to China's immature domestic legal structure, lack of transparent and uniform administration, and poor training.[28]

Capital Controls

Another key WTO commitment made by China was to allow foreign banks to conduct foreign currency business with Chinese firms and private individuals immediately upon accession. Within two years of accession, foreign banks were supposed to be able to conduct domestic currency (i.e., renminbi "yuan") transactions with Chinese firms. Within five years, foreign banks should be able to conduct full domestic currency business in China with both firms and private individuals.[29]

Nearly two years after WTO accession, China has yet to permit any foreign banks to compete in China's financial services market. Citibank and the Hong Kong and Shanghai Banking Corporation—the only two foreign banks licensed in China—are doing local currency business consistent with China's geographic phase-ins (i.e., still in select cities), although the types of products they are entitled to offer remain circumscribed.

The Chinese have managed to keep out all other foreign banks by imposing working capital requirements and other prudential rules that are so far in excess of international standards that few foreign banks—and no Chinese banks—can meet them. Moreover, the applications of the banks that have applied to broaden their market presence are languishing in the in-boxes of China's central bank.[30] Foreign insurance service providers are similarly hamstrung by China's impossible regulatory structure—again, in violation of China's WTO commitments.

24. Scott Thurm, "Cisco Ran Sting Operation to Nab a Copycat in China," *The Wall Street Journal*, April 4, 2003, at *online.wsj.com/article/0,,SB104942212126672500,00.html*.

25. See U.S. General Accounting Office, *Export Controls: Department of Commerce Controls over Transfers of Technology to Foreign Nationals Need Improvement*, GAO–02–972, September 2002.

26. See Jimmy Chuang, "Industrial Espionage Investigation Turns to E-mail Recipient," *Taipei Times*, March 10, 2002, at *www.taipeitimes.com/news/2002/03/10/story/0000127077*, and "Ex TSMC Employee Suspected of Selling Secrets to Shanghai," *Taipei Times*, March 7, 2002, at *www.taipeitimes.com/news/2002/03/07/story/00001266*.

27. See "Company's Secret Theft Claims Leaves TSMC Looking Dumb," *Taipei Times*, March 20, 2002, at *www.taipeitimes.com/news/2002/03/20/story/0000128440*.

28. Agence France-Presse, "Japan Urges China to Stamp Out Piracy, Abide by WTO Rules," *Taipei Times*, March 29, 2003, at *www.taipeitimes.com/News/biz/archives/2003/03/29/199937*.

29. Office of the U.S. Trade Representative, *2002 Report to Congress on China's WTO Compliance*, p. 36.

30. *Ibid.*, p. 41. This information is current as of September 2003 according to an e-mail from the U.S. Trade Representative's China office.

Exhibit 31

Report to the President

GLOBAL STEEL TRADE

Structural Problems and Future Solutions

July 2000

International Trade Administration

U.S. Department of Commerce

Import Substitution Program. China, like other countries, is also concerned about maintaining the price competitiveness of domestically produced steel inputs vis-á-vis imports. In 1998, China implemented the Steel Import Substitution Program (SISP), which sets import substitution targets for China's largest steel producers. The SISP is designed to stimulate domestic production capability at the high end of the steel market, *e.g.*, stainless steel and cold-rolled sheet for automotive applications. The industrywide substitution target for 1999 was 3 million MT.[79]

Under the SISP, steel producers receive a rebate of the 17 percent VAT on sales to steel users who produce for export and who would otherwise import to meet their needs. The SISP effectively lowers by the amount of the VAT rebate the price that these steel producers can charge for their steel.[80] The rebate appears to be working as intended, as twelve of the 27 steel producers that signed import substitution contracts—including Baoshan, Wuhan, Shougang, and Anshan—exceeded their targets. The industrywide target for 2000 under the SISP is thought to be 3 million MT.[81] Baoshan remains the primary investment vehicle for producing import substitutes under the government's broad steel import substitution policy. Consistent with that fact, Baoshan had a 1999 import substitution target under the SISP of 1.3 million MT—three times as great as the next largest, Wuhan's 400,000 MT target.[82]

Subsidies Disciplines. China is expected to be subject to strong subsidy disciplines under the WTO Agreement on Subsidies and Countervailing Measures, including the immediate elimination of export subsidies and import substitution subsidies and certain additional disciplines that take into account the special characteristics of China's economy and, in particular, of its state-owned enterprises. As a WTO member, China will not be precluded from continuing to provide government support to Baoshan, Anshan, Wuhan, and Shougang for technological upgrading and transformation, although this effort will be subject to discipline through the enforcement of U.S. rights under the Agreement on Subsidies and Countervailing Measures.

Prohibition on Foreign Distributors. It is anticipated that China will commit to eliminate, after a short phase-out period, its prohibition on foreign companies distributing imported steel products in China or providing related distribution services. When this phase-out period ends, foreign companies will be permitted to engage in a full range of distribution services.

Added Protections Against Dumping. It is not clear when the Chinese steel industry will shift its focus to the development of export markets, but when it does, the terms of China's WTO accession should provide the United States with the means to safeguard the U.S. steel industry from unfair trade. In addition to enforcing subsidy disciplines under the Agreement on Subsidies and Countervailing Measures (including the prohibition on export and import substitution subsidies) the United States will be able to use its current nonmarket economy methodology in antidumping proceedings for fifteen years after China's accession. The United States will also be able to use a strong product-specific safeguard to address import surges for twelve years after China's accession.

Assessment of Export Potential

Although the export potential of China's steel industry is not what the size of the industry might suggest, it is nevertheless a concern because of the government's firm commitment to steel as a strategic industry and involvement in investment planning. It is likely that Baoshan will be an internationally competitive exporter of high-end products in the near future. While Chinese government representatives and private industry analysts expect Baoshan to become an internationally competitive exporter in the next two to three years, traders and steel consumers expect Baoshan to reach this level much sooner. Although some of Baoshan's most demanding customers express concern with its quality control, less technically demanding consumers are concerned only with the fact that