



May 19, 2004

James J. Jochum
Assistant Secretary for Import Administration
U.S. Department of Commerce
Central Research Unit
Room 1870
Pennsylvania Ave. & 14 St., N.W.
Washington, D.C. 20230

Re: China as a Market/Non-Market Economy
for Purposes of the U.S. Antidumping Law

Dear Mr. Jochum:

The Semiconductor Industry Association ("SIA") submits this letter in response to the Federal Register notice dated May 3, 2004 inviting comments from interested parties with respect to China's progress toward market economy status for purposes of the administration of the U.S. Antidumping Law (69 FR 24132). SIA represents 95 U.S.-based producers of semiconductors, comprising over 85 percent of U.S. production of semiconductors. Since the early 1990s SIA has devoted a major effort to ensure that China is integrated into the international trading system.

While China has made progress, it is not yet ready to graduate to market economy status. SIA looks forward to working with China to make the eventual transition to market economy status under the U.S. Antidumping Law.

Procedural Issues

The SIA emphasizes that the United States has a preexisting procedure for determining whether China should be considered a market economy for purposes of the administration of the U.S. antidumping law. On November 10, 2001, China became part of the World Trade Organization pursuant to the Accession of the People's Republic of China.¹ The Accession Agreement provides that WTO Members have the right to treat China as a non-market economy for fifteen years after the date of accession, unless China establishes that it is a market economy.² Moreover, in order to disprove non-market

¹ WTO, Accession of the People's Republic of China (Decision of November 10, 2001) WT/L/432 (November 23, 2001)

² *Id.* § 15(d).

economy status, the Chinese producers under investigation in an antidumping investigation have the burden to “clearly show {under the national law of the importing Member} that market economy conditions prevail.”³ This commitment was a vital part of China’s overall accession package, and was central not only to industry support of for accession and Permanent Normal Trade Relations (PNTR) but was also of paramount importance to lawmakers who voted in favor of the deal.

The SIA urges the U.S.-China Joint Commission on Commerce and Trade Working Group on Structural Issues to uphold this preexisting procedure which was carefully negotiated over an extended period of time.

The SIA would also like to note, as a preliminary matter, that the procedure specified in the Federal Register notice seems extremely rushed and prone to error. Comments on an issue as important and comprehensive as whether or not China is a market economy should be afforded more than a 19-day period.

Importance of the Antidumping Law

The U.S. Antidumping Law is important to the semiconductor industry, especially in light of the history of injurious dumping which has occurred in this sector. Manufacturing advanced semiconductors requires billions of dollars of investments in plant, equipment, research, and development— it is vital that the companies that make these investments be able to compete on a fair basis in order to recoup the enormous investments. In the mid-1980s Japanese dumping of DRAM devices drove 9 out of 11 U.S. producers out of this product market, and only the timely application of U.S. antidumping measures prevented a similar outcome in EPROMs. The kinds of market distortions abroad which gave rise to those episodes continue to exist, and underscore the need to maintain an effective antidumping remedy.

A comprehensive effort undertaken by China’s government to promote its semiconductor industry since 2001 has resulted in the rapid construction and expansion of new wafer fabrication facilities in China. In the absence of Chinese government promotional measures, particularly a preferential value-added tax that discriminates in favor of local production, much of this capacity would not have been built. The risk exists that if Chinese domestic demand stagnates or declines, the newly-established facilities will resort to dumping in export markets, as has occurred in similar situations involving other countries in the past. Maintaining the integrity of the antidumping remedy -- including the proper application of the non-market economy rules -- is therefore of great importance to the U.S. semiconductor industry.

³ *Id.* § 15(a)(ii).

As discussed above, when China joined the WTO, it accepted terms of accession that permit other WTO members to treat it as a nonmarket economy for the first 15 years of its membership. The burden is placed on China to establish under the national law of the importing WTO member, that “market economy conditions prevail.”⁴

Changes in China’s Economy

Under the Tenth Five Year Plan (2001-2005) China has made significant steps toward reducing command-economy policies in favor of more market-oriented measures. However work remains to be done.

Since the accession of the Communist Party to power, China has implemented 5-year plans governing its economy. The 5-year plans set forth comprehensive promotional plans for key industries, including in particular the semiconductor industry. The Tenth Five Year Plan provides that by 2005, “60 percent of IT products should be homegrown, and China shall gradually design and develop its own IC products (including CPU).” The government set a goal of ensuring that domestic production of integrated circuits will “meet the majority of domestic market demand” by 2010 and enable the industry to “export a certain amount.” Comprehensive promotional measures are set forth in the State Council Circular 18 of June 24, 2000. These represent a departure from command-economy style controls and more closely resemble industrial policy tools found in western countries -- subsidies, tax incentives, the creation of industrial development zones, and government programs to support training and R&D.

One promotional measure in the semiconductor industry, a discriminatory value-added tax which favors domestically designed and produced devices over imports, is currently being challenged by the United States under WTO dispute resolution procedures as a breach of China’s obligations under GATT Article III, which prohibits the application of internal taxes in a manner which discriminates against imported products.

But while some recent moves by China to adopt western-style policy tools have taken place, substantial nonmarket structures, practices and policies remain. Most Chinese semiconductor enterprises are still state-owned or are 50-50 joint ventures between foreign firms and governmental organizations in which the government entities typically exercise the leading role. While numerous new Taiwanese-owned semiconductor foundries are springing up in China, their ownership structure and the degree of Chinese government involvement is partially or wholly opaque because they are not required to publicly disclose basic financial or ownership information. National,

⁴ WTO, *Accession of the People’s Republic of China* (Decision of November 10, 2001) WT/L/432 (November 23, 2001), Section 15(d).

regional and local governments have combined to provide a very favorable environment for local semiconductor design and production, but this reflects the comprehensive channeling of resources and government policy support to a favored sector. While the number of so-called “venture capital companies” is rising, these are typically government-owned, derive their capital from the government, and direct their investments to support government policy objectives.

The role of national and regional governments in all sectors, including semiconductors, remains pervasive. While China is actively encouraging foreign investment in semiconductors, maintaining “good relations” with the various levels of government is absolutely imperative for any foreign investor in this industry. Government procurement represents a significant proportion of China’s end-use markets for telecommunications equipment, computer systems and other IT products that incorporate semiconductors. Government entities also influence the procurement decisions of both state-owned and private Chinese enterprises. Government entities control the establishment of standards that will define China’s rapidly growing IT electronics markets, and have clearly demonstrated a tendency to develop localized standards that favor domestic firms in a non-transparent process. Foreign-invested firms are completely dependent on the discretion and the good will of local authorities to enforce their intellectual property rights. Government agencies regulate the provision of resources, support services, and goods and materials moving in international trade to manufacturing operations located in China, and are in a position to cut red tape and clear away bureaucratic impediments -- or not -- as the case may be. Such factors have served as a continuing deterrent to direct investment by some U.S. high technology firms, notwithstanding the numerous investment incentives China now offers.

Factors Identified by the Department

In its notice of hearing the Department identified several factors relevant to China’s market economy status. An examination of these factors as they bear on the semiconductor industry indicates that China remains at best in a transitional phase between nonmarket and market economy status.⁵

⁵ The NME provision of the Antidumping Law was drafted to accord market economy status only to countries which have fully transitioned into market economies, not countries “in transition” which have implemented various partial or incomplete reforms. The creation of a hybrid category to govern economies-in-transition was rejected by Congress and the Department when it was proposed in 1995. See Robert H. Lantz, “The Search for Consistency: Treatment of Nonmarket Economies in Transition Under United States Antidumping and Countervailing Duty Laws,” 10 *American University Journal of International Law and Policy* 993 (1995).

Banking sector. The Chinese government owns the banking system and influences its lending policies in order to support government industrial policy priorities. The central government maintains a catalog of “national encouraged industries” (including semiconductors) which serves as a reference book for Chinese banks considering loans to domestic industries. Since 1995 China’s major national banks have been divided between “policy banks” that make loans explicitly for policy purposes, and “state banks” that are supposed to operate along commercial lines. Most loans by Chinese banks to the semiconductor industry in recent years have been by the state banks, but the lending policies of the regional branches of the state banks are influenced by the policies of the regional governments, which in Beijing, Shanghai and Suzhou emphasize the promotion of the semiconductor industry.⁶ Pursuant to the Tenth Five Year Plan, interest rates on bank loans to semiconductor firms are subsidized.

State-owned enterprises. China’s semiconductor industry originally consisted entirely of state-owned enterprises (SOEs) established between the early 1960s and the late 1980s, and many of these entities are still operating, notably Huajing and Huayue.⁷ Beginning in the mid-1990s China began encouraging the formation of 50-50 joint ventures between a foreign investor, on the one hand, and one or more Chinese government organizations, on the other hand. Such joint ventures now include Shanghai Belling, Advanced Semiconductor Manufacturing Corp., Mitsubishi Stone, Shougang NEC, and Shanghai Huahang NEC. Finally, new semiconductor enterprises are being established which are majority-owned by foreign enterprises, but in which Chinese government entities hold a minority equity interest, including the Beijing Semiconductor Manufacturing Corp., Semiconductor Manufacturing International Corp., and Nanjing Semiconductor Manufacturing Corp. Grace Semiconductor Manufacturing Corp., based in Shanghai, has indicated that it is wholly owned by private investors (although the identity of those investors is not publicly available), and Taiwan’s TSMC is establishing a wholly-owned subsidiary in China without Chinese government participation, but these are exceptions in an industry in which government entities retain a major ownership interest in most manufacturing enterprises.

Chinese semiconductor R&D and design was traditionally carried out solely in government research institutes, and such institutes still dominate Chinese R&D in this industry. An increasing number of government research institutes have been or will be spun off into private entities, but government organizations commonly retain an equity

⁶ Semiconductor Manufacturing International Corporation (SMIC), China’s largest semiconductor manufacturer, received \$480 million in financing from both national and regional government banks, including the Industrial and Commercial Bank of China, the China Construction Bank, and the Shanghai Pudong Industrial Bank.

⁷ Other currently operational wholly state-owned semiconductor manufacturers include Guangdong Xinhui Guifeng, Tianshui Yonghong, Shanghai Huaxu, and Jiangyin Changjiang.

position in such new enterprises. China has a small but rapidly growing number of private integrated circuit design firms which commonly receive financial support from regional governments.⁸

Tax incentives. Semiconductor manufacturing and design firms in China enjoy so many tax breaks under various promotional laws that it is likely that most of them will pay little, if any tax during the next decade. Pursuant to State Circular 18 of June 2000, semiconductor manufacturers enjoy a five-year tax holiday beginning in the first year that an enterprise is profitable. The short depreciable life permitted under Chinese tax rules for semiconductor manufacturing equipment enables a semiconductor enterprise to postpone the beginning of the 50-year “eligibility clock” for the tax holiday by deferring the year in which profitable results are first shown. Additional tax holidays and exemptions are provided in the High-Tech Parks and Industrial and Technical Development Zones in which most semiconductor enterprises are located. These measures combine to enable the semiconductor industry to exist, in effect, as a tax-free “island” in an economy in which taxation is unpredictable, non-uniform and subject to manipulation by local officials.

Tax rates for individuals working in technology-intensive businesses located in Hi-Tech Parks often reflect special concessions offered by the Park authorities, which vary from location to location and person to person. For example, tax refunds may be given to individuals for use in purchasing a house or car. Such refunds are a form of unpublished tax benefit that varies from case to case, depending on factors such as the level of technology associated with the individual’s work and the size of the enterprise at which they are employed. Such measures are not uniform or transparent.

Factors Cited in the NME Statute

The provision in the U.S. Antidumping Law which establishes non-market economy rules (19 U.S.C. § 1677(19)(B)) sets forth six criteria for determining the existence of a market economy. Application of these standards with practical reference to the semiconductor industry presents a mixed picture with respect to China, with more progress evident under some criteria than under others. These would need to be examined fully in any future analysis, which is not possible given the short time frames.

1. The extent to which the country’s currency is freely convertible.

According to the Chinese government sources, “China still implements rigid exchange controls.”⁹ These include restrictions on capital account transactions (direct investment,

⁸ SIA, *China’s Emerging Semiconductor Industry*, op. cit, pp. 116-20.

⁹ Wu Xiaoling, Vice President of the Peoples’ Bank of China, was recently quoted by *Xinhua*, the state news agency. “Central Bank has no Plan to Raise Interest Rates,” *Xinhua* (April 21, 2004).

international loans, and securities) and restrictions on use of foreign exchange by foreign-invested enterprises.¹⁰ In addition, domestic companies involved in foreign trade maintain foreign currency bank accounts which are subject to government-designated quotas, with exporters required to sell their foreign exchange in excess of the quotas to the central bank.

2. The extent to which wage rates in the foreign country are determined by free bargaining between labor and management. Given governmental and political controls over the population at large this is a difficult question to answer. However China's rapidly-expanding semiconductor industry has given rise to intensive competition for the kind of educated, skilled workers that are required to design and manufacture semiconductors. In what is, in effect, a sellers' market for skilled workers, enterprises and regional governments are providing substantial incentives to attract and hold engineers, production workers and design personnel.¹¹

3. The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country. China is actively courting inward foreign direct investment in the semiconductor industry. However some trade distortive practices, such as the discriminatory VAT tax and a failure to fully enforce intellectual property rights, have significant impacts on inward investment. Recently China attempted to use certain standard setting procedures to force joint-manufacturing activity.

4. The extent of government ownership or control of the means of production. There remains a very significant degree of government ownership and/or control of semiconductor production facilities in China. See the discussion above under the heading "State-Owned Enterprises" and "Banking Sector," as well as the discussion of the Tenth Five Year Plan and Circular 18 of 2000.

5. The extent of government control over the allocation of resources and over the price and output decisions of private enterprise. Regional governments and the administering authorities of China's High-Tech Parks and Industrial and Technical Development Zones in which semiconductor enterprises are located are providing assets and production inputs to those enterprises on preferential terms. Sophisticated infrastructures have been established by regional authorities and Park administrations to support the design and manufacture of semiconductors. Land and structures are provided free or at very low rental rates. Water, specialty gases, electricity and other factors of production are provided on a concessional basis. Design firms are provided with IC

¹⁰ For a comprehensive summary of current exchange restrictions see Economist Intelligence Unit, *China: Forex Restrictions* (April 28, 2004).

¹¹ SIA, *China's Emerging Semiconductor Industry*, op. cit., pp. 112-16.

design tools on a subsidized basis.¹² While these measures create a favorable cost environment for foreign enterprises, they also serve to illustrate the degree of influence and control exercised by government authorities over the factors of production.

6. “Such other factors as the administering authority considers appropriate.” The Department has traditionally considered a number of factors under this criterion, which are briefly addressed here.

– ***Development of the judicial system and the prevalence of the rule of law.***¹³ Since the chaos of the Cultural Revolution, China has made progress in enacting a comprehensive system of criminal, civil and economic law, establishing a functioning judiciary, and training lawyers. However, the working of interrelationships between the laws, regulations and orders of state, regional and local authorities is often confusing, nontransparent, and non-uniform; corruption is widespread despite concerted government efforts to stamp it out; the independence of the judiciary remains limited; and a pattern persists of nontransparent and arbitrary actions by local government officials.

– ***The soundness and solvency of the banking system.***¹⁴ As noted above, the government of China owns and directs the banking sector, and loan decisions commonly reflect government priorities rather than commercial considerations. Bank loans have traditionally been a principle source of financing for China’s numerous state-owned enterprises (SOEs), and many of these loans have reportedly become nonperforming. As a result of a massive overhang of bad loans some banks are probably insolvent, although government policies that restrict savings options tend to channel savings resources into banks, helping them maintain their liquidity. The quality of lending is reportedly improving, albeit slowly, and may result in the eventual emergence of a “solvent” and “sound” banking system.

– ***A well-functioning bankruptcy law.***¹⁵ China enacted a bankruptcy law governing SOEs in 1988, and legislation regulating bankruptcies of non-state-owned enterprises and other legal entities was enacted in 1991. While the number of bankruptcies has increased steadily since the early 1990s, numerous weaknesses characterize the current system. With respect to SOEs, the government controls the

¹² SIA, *China’s Emerging Semiconductor Industry*, op. cit.

¹³ See U.S. Department of Commerce Internal Memorandum from B. Carreau to R. LaRussa, Case No. A-859-801 (Slovakia NME Review), pp. 13-14.

¹⁴ U.S. Department of Commerce Internal Memorandum from C. Smith and K. Whitson to T. Cribb, Case. No. A-449-804 (January 10, 2001) (Latvia NME Review), p. 1.

¹⁵ Latvia NME Review, op. cit., p. 4; Slovakia NME Review, op. cit., p. 4; U.S. Department of Commerce Internal Memorandum from J. Brinkman and N. Cannon to R. LaRussa, Case No. A-851-802 (November 29, 1999) (Czech Republic NME Review), p. 4.

number, scale and speed of bankruptcies and decides what sectors are (or are not) covered under the bankruptcy law. Bankruptcy judges are typically inexperienced and constrained by national and local politics that conflict with bankruptcy rules. SOE bankruptcy procedures are “vague” and those governing non-SOE bankruptcies are “deficient.” SOEs are commonly owned by multiple government bodies that “frequently evade their responsibilities when an SOE is faced with bankruptcy.”¹⁶ The government appears committed to reforms of the bankruptcy system designed to address these and other systemic problems.

For ten years SIA has worked closely with the Chinese government and the domestic semiconductor industry to address legal, regulatory and structural factors which have limited the integration of China’s semiconductor industry and its market into the global system. As reforms have been implemented, SIA has supported China’s membership in a variety of multilateral institutions. Reflecting the fact that many of the original problems have been overcome or are on their way toward resolution, SIA supported China’s accession to the WTO and is currently seeking the Chinese industry’s entry into the World Semiconductor Council, comprised of industry representatives from the leading semiconductor producing countries. However the treatment of China under the antidumping law presents a host of complex issues, many of which have been addressed in prior cases and agreements. Any work in this area should be deliberate and provide for a full opportunity for analysis. China is not yet a market economy and cannot be afforded market economy treatment at this time -- the timeline recently agreed to when China joined the WTO remains valid.

Respectfully submitted,



George M. Scalise
President

¹⁶ Li Shuguang, “Bankruptcy Laws in China: Lessons of the Past Twelve Years,” *Harvard Asia Quarterly* (May 12, 2004).