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May 19, 2004

Via e-mail: webmaster-support@ita.doc.gov

James J. Jochum
Assistant Secretary for Import Administration
Subject: Public Hearings on U.S.-China Joint Commission on
Commerce and Trade Working Group on Structural Issues
U.S. Department of Commerce
Central Records Unit, Room 1870
Pennsylvania Avenue and 14th Street, NW
Washington, DC 20230

Re: Comments of Stewart and Stewart in Response to the Federal Register Notice of May 3, 2004 and Notification of Intent to Testify at Hearing.

Dear Mr. Jochum:

Our firm has followed with interest the recent U.S.-China Joint Commission on Commerce and Trade meeting, the resulting announcement of the establishment of a working group on steps that would need to be taken for China's economy to be viewed as a market economy under U.S. antidumping law and the May 3rd Federal Register request for comments. In addition to representing clients before the Department of Commerce in particular antidumping proceedings involving goods from China, our firm has also closely followed the accession negotiations that led to China's acceding to the WTO in late 2001 and we have prepared two reports for the U.S.-China Commission since China's accession to the WTO looking at the compliance of China with the myriad obligations that membership in the WTO requires. Both of the reports to the U.S.-China Commission are accessible via the Commission's website [http://www.uscc.gov]. While the focus of the reports is WTO-compliance, there is a great deal of information contained in the reports that would be relevant to the inquiry being undertaken. The following comments are submitted on behalf of our firm and are responsive to the May 3, 2004 Federal Register notice, 69 Fed. Reg. 24132-33.

"RANGE OF ISSUES THAT ARE RELEVANT TO CONSIDERING CHINA'S DESIRE TO NO LONGER BE TREATED AS A NON-MARKET ECONOMY"

As the Department is aware, "non-market economy" is defined by statute in Section 771(18) of the Tariff Act of 1930, as amended:

> **(18) Nonmarket economy country.**
>
> **(A) In General.**
>
> The term 'nonmarket economy country' means any foreign country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise.
>
> **(B) Factors to be considered.**
>
> In making determinations under subparagraph (A) the administering authority 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 foreign countries are permitted in the foreign country,
> (iv) the extent of government ownership or control of the means of production,
> (v) the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and
> (vi) such other factors as the administering authority considers appropriate.

19 U.S.C. § 1677(18).

In the Department's Federal Register notice of May 3 (69 Fed. Reg. at 24133), the agency states that:

> Among the more specific issues that would be taken up under this agenda would be structural characteristics of the Chinese economy that appear to be inconsistent with the normal experience of a market economy, as well as Chinese government policies and practices which have the potential to distort the market and U.S.-China trade. Examples of the types of structural issues envisioned for these discussions include China's banking sector and state-owned enterprises, as well as central, provincial, and regional governmental policies such as tax incentives and other export promotion instruments.

We believe that the statutory standard and the focus of the Department's Federal Register notice are appropriate benchmarks for evaluating when China's reforms would permit the country to be treated as a market economy. While China has undertaken significant reforms as part of its effort to join the WTO and in more recent years to comply with its obligations, there remain many distortions within the Chinese economy which result in trade flows (or the lack of trade flows) that are not in keeping with the functioning of a market economy. Because of China's importance to the global trading system and the unprecedented bilateral trade deficit that the U.S. has with China, it is important that the full array of distortions be addressed prior to China's being accorded market economy status. Maintaining such a position is in the interests of not only the United States but those interests within China that are promoting economic reform.

In the materials which follow, we recommend that the United States use benchmarks which compare China's performance on many factors against other major trading nations, the members of the OECD. While such countries typically are more economically advanced than China has been, the size and potential of China in the global economy suggest that such other countries are appropriate benchmarks for determining whether China's practices conform to market economy standards.

The remaining comments review the statutory criteria and suggested additional criteria under "such other factors as the administering authority considers appropriate," perceived performance questions and suggested standards for the Department's evaluation.

1. Currency convertibility

While the Chinese currency is technically convertible, the reality is that China maintains a maze of currency exchange controls and keeps its currency pegged to the dollar at a very narrow range. Chinese currency is still not convertible for the purpose of a capital account transaction, such as capital exporting.[1]

With very large productivity gains in recent years and large affirmative trade balances over the last decade, nearly all economists concur that China's currency is substantially undervalued, with some estimates ranging as high as 75%.[2] There is no serious question that such practices are highly distortive of the market and U.S.-China trade.

Indeed, an undervalued currency reduces imports by imposing a hidden tax/duty on imports and essentially subsidizes exports by making them artificially inexpensive. So problematic is China's control of its exchange rate and so distortive of U.S.-China trade that a Fair Currency Alliance has come together in the United States consisting of manufacturing, labor, and service providers to press for an immediate revaluation of the currency by around 40% and is prepared to file a 301 petition on the issue if necessary. Speaking of a potential petition,

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1 *See* Jian Yang and David J. Leatham, *Currency Convertibility and Linkage Between Chinese Official and Swap Market Exchange Rates*, Western Economic Association International, Vol.19, No. 3, July 2001, at 347.

2 *See* Fair Currency Alliance, Chinese Currency Manipulation Fact Sheet (May 10, 2004).

Ambassador Zoellick said: "We do not need a year-long investigation to know that we have serious concerns with China's policies on the value of its currency."[3]

The Administration is working with the Chinese government to provide technical support and there are indications that China understands that it is in its economic interests to obtain a situation where the currency freely floats. Indeed, China has amassed more than $430 billion[4] in foreign exchange reserves in recent years which has been generating huge inflationary pressures within China[5] as the local currency has expanded nearly 20% in the last year[6].

We believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China has dismantled the currency exchange/controls and has obtained a freely floating currency.
- At a minimum, the currency should be valued at a level that approximates the underlying value vis-à-vis the U.S. dollar.

2. <u>Wages freely set</u>

For many manufactured and agricultural goods and for many services, labor costs can be a significant part of total costs. In market economies, workers generally enjoy various rights including what the ILO has identified as the internationally recognized core principles of (1) freedom of association and the effective recognition of the right to collective bargaining; (2) freedom from forced labor; (3) the effective abolition of child labor and (4) nondiscrimination in employment. While China reports adherence to at least some of the core labor standards, significant problems have been identified by the U.S. government, various NGOs and U.S. labor in China's current labor situation.

With regard to China's compliance with core labor standards,[7] a common theme expressed by observers is not the existence of legal guarantees but a failure to implement the guarantees provided. This does not mean that China does not have laws or doesn't have certification processes for companies wishing to establish compliance with certain standards. For example, China has issued a Social Accountability Standard (SA8000)[8] in 1998 ostensibly

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3 USTR press release 2004-32, April 28, 2004(Statement of U.S. Trade Representative Robert B. Zoellick on U.S.-China Trade Relations).

4 *See* http://www.chinadaily.com.cn/english/doc/2004-05/17/content_331184.htm.

5 http://www.nytimes.com/2004/04/14/business/worldbusiness/14yuan.html?ex=1084939200&en=46c6515aab99f8d4&ei=5070

6 *See* http://biz.yahoo.com/rf/040512/economy_china_money_3.html.

7 ILO Declaration of Fundamental Principles and Rights at Work, June 1998.

8 Social Accountability International web site: http://www.cepaa.org/SA8000/SA8000.htm.

allowing companies to obtain SA8000 certification. This Standard requires companies to adhere to the following international labor and UN conventions: ILO 29 and 105 (Forced Labor); ILO 87 (Freedom of Association); ILO 98 (Right to Collective Bargaining); ILO 100 & 111 (Equal Pay for Equal Work; Discrimination) {note: these are also two of the three ILO conventions that China has ratified[9]}; ILO 135 (Workers Representatives); ILO 138 & 146 (Minimum Age); ILO 155 & 164 (Occupational Safety and Health); ILO 159 (Vocational Rehabilitation/Disabled Persons; ILO 177 (Home Work); ILO 182 (Worst Forms of Child Labor) {note: also ratified by China); the United Nations Convention on the Rights of the Child; and the United Nations Convention to Eliminate All Forms of Discrimination Against Women.

Nonetheless, serious labor issues continue to exist in China on all of the core labor standards as reviewed below.

(A) Freedom Of Association And The Right To Collective Bargaining

- "The (Chinese) 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 (ACFU) which was controlled by the Communist Party and headed by a high level party official was the sole legal worker's organization. The Trade Union law gives the ACFU control over the establishment of all subsidiary union organizations 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 are no reports of repercussions for the small percentage of workers in the state-owned sector that had not joined. Independent Unions are illegal."[10]
- The freedom to strike, though allowed in law, is not allowed in practice. "[G]overnment treatment of worker rights 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."[11]
- Amnesty International reported numerous instances of workers protesting low wages, low or missing wages, corrupt management, illegal working conditions, industrial accidents and death, physical ill-treatment and other forms of exploitation and abuse. Such protests were generally deemed illegal, as are independent trade unions. Protestors have seen arrests, beatings, criminal charges such as "subversion" for revealing "state secrets" in response to their attempts to improve worker conditions.[12] This treatment of workers needs to be ended and its end documented by independent observers, as a simple change of law means little in China where the rule of law has not

9 International Labor Organization database of International Labor Standards at http://www.ilo.org/ilolex/english/docs/declAS.htm.

10 U.S. Department of State Country Report on China, 2003, February 25, 2004, p. 34.

11 U.S. Department of State Country Report on China, 2003, February 25, 2004, p. 36.

12 Testimony by T. Kumar, Advocacy\Director for Asia & Pacific, Amnesty International USA, September 11, 2003.

taken firm root. Presently, access for NGOs to monitor human rights in China is severely circumscribed.[13]

- The ability of Chinese workers to relocate to better jobs is restricted because they require government approval to change their place of residence or workplace because of the system of household registration ("Huko"). While the system is being liberalized, it still exists and the government can , at its choosing, restrict movement of persons.[14] The registration system should be abolished to allow workers to change jobs freely. Restrictions on the right of workers to choose their employment are major impediments to the functioning of a market economy.
- Chinese respect for internationally recognized workers rights were below international norms and did not improve in 2003.[15]
- While Chinese labor law, aside from freedom of association and the right to collective bargaining generally follows ILO conventions, this is irrelevant since the government does not enforce the laws.[16]

(B) Elimination of Forced or Compulsory Labor

- The (Chinese) government continued to deny internationally recognized worker rights, and forced labor in prison facilities remained a serious problem.[17]
- In 2003, over 250,000 people were serving sentences, not subject to judicial review, in "reeducation through labor" camps. In April, inmate Zhang Bin was beaten to death in a reeducation through labor camp.[18]

(C) The Elimination Of Child Labor

- Although Chinese law prohibits child labor, it has no comprehensive policy to eliminate it,[19] and there have been reports of death and injury among children working in factories, such as the deaths of 34 schoolgirls in a fireworks factory explosion.[20]
- A Tulane University report identifies child labor as a major social problem in China, despite the Compulsory Education Law of the Chinese Constitution. The government sees child labor as one way to combat poverty and does little to enforce relevant laws.[21]

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13 U.S. Department of State Country Report on China, 2003, February 25, 2004, p. 3.

14 U.S. Department of State Country Report on China, 2003, February 25, 2004, p.25.

15 Congressional-Executive Commission on China, Annual Report, 2003, p. 23.

16 Congressional-Executive Commission on China, Annual Report, 2003, p. 24.

17 U.S. Department of State Country Report on China, 2003, February 25, 2004, p.3.

18 U.S. Department of State Country Report on China, 2003, February 25, 2004, p. 2.

19 U.S. Department of State Country Report on China, 2003, February 25, 2004, p.31.

20 U.S. Department of Labor, Bureau of International Labor Affairs Report, available at http://www.dol/ilab/medi/reports/iclp/sweat/china.htm.

- From July 28-August 1, 2003, four fireworks plants exploded, killing at least two children, ages 15 and **4**. A fire at a fireworks factory in 1992 killed 20 workers, most of whom were between 9 and 14 years of age.[22] In March 2001, another fireworks plant exploded, killing from 41-60 children.[23]
- In 1999, the ILO adopted Convention 182, Eliminating the Worst Forms of Child Labor.

(D) The Elimination Of Discrimination In The Workplace

- China has not implemented its laws protecting women against discrimination, leaving women vulnerable to pervasive abuse, discrimination at home and in the workplace.[24]

The array of problems that exist at the present time in China was recently documented by American labor. Specifically, in March 2004, the AFL-CIO filed a 301 petition which reviewed a host of problems with the current level of implementation of internationally recognized core labor standards in China. While the 301 petition was not accepted by the Administration, it wasn't because the Administration perceived there weren't problems. Rather, as stated by Ambassador Zoellick on April 28th, "today we announce that the U.S. and China are launching a comprehensive joint effort aimed at the effective implementation by China of International Labor Organization (ILO) core labor standards." Ambassador Zoellick also said in the same press release: "We do not need a year-long investigation to know that there are serious concerns with labor rights and working conditions in China, as there are in many developing countries."[25]

What is clear from the above, is that core labor standards are not yet fully implemented within China. Such lack of implementation can and does distort the marketplace and competition between US and Chinese goods and services in China, in the US and in third countries.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China has fully implemented ILO core labor standards (and the related topic of dramatic improvement in its record on human rights).

3. Joint ventures and other investments

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21 Child Labor in China, http://tulane.tcs.tulane.edu/~rouxbee/kids/99/china2.html.

22 U.S. Department of Labor, Bureau of International Labor Affairs report, http://www.dol/ilab/medi/reports/iclp/sweat/china.htm.

23 China Labour Bulletin, http://www.china-labour.org.hk.

24 Congressional-Executive Commission on China, Annual Report, 2003, p. 42.

25 USTR press release 2004-32, April 28, 2004 (Statement of U.S. Trade Representative Robert B. Zoellick on U.S.-China Trade Relations).

While China has significantly opened its market to foreign investment and in 2003 became the largest destination for foreign investment, China has not fully implemented its obligations to give foreign-owned and foreign-invested businesses full trading rights in a timely manner under its WTO accession obligations. The recent U.S.-China JCCT promises correction of the problem and advance implementation of remaining trading rights obligations.

At the same time, China has restricted investments in a wide range of areas to permit the development of national champions. China still maintains control over, and imposes restrictions on, foreign investment, both direct and in joint ventures. Some of these restrictions are:

- Foreign investors in services must do so through a joint venture with a Chinese partner. Foreign investors are subject to high capital requirements.[26]
- China officially prohibits foreign investment in producing genetically modified seed, mining of radioactive substances, production of pharmaceutical products, postal services, financial futures, construction of power networks, and some other traditional products such as herbal medicine, enamel products, etc.[27]
- China officially restricts foreign investment in farming, fishery, mining, food processing, tobacco, and other industries.[28]
- China has not fully implemented its WTO accession obligation to grant trading rights to foreign-invested companies.[29]

Moreover, China committed to eliminate the practice of forcing technology transfer for companies to be able to invest in China and to bring itself into compliance with WTO TRIMs obligations by accession. However, while China revised its laws and regulations concerning foreign-invested enterprises to make them compliant with its WTO obligations, and to eliminate investment requirements such as export performance, local content, and technology transfer, USTR notes that:

> [S]ome measures continue to "encourage" technology transfer, without formally requiring it. U.S. companies are concerned that this "encouragement" will in practice amount to a "requirement" in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications. In addition, according to U.S. companies, some Chinese government officials in 2003 still considered factors such as export performance and local content when deciding whether to approve an investment or to

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26 The U.S.–China Business Council Report on Foreign Investment in China, 2002.

27 China Association of Development Zones, www.cadz.ord.cn/en/tzzg/zdm118.asp.

28 China Association of Development Zones, www.cadz.ord.cn/en/tzzg/zdml15.asp.

29 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 59.

recommend approval of a loan from a Chinese policy bank, which is often essential to the success of an investment project.[30]

Such practices are not consistent with the practice of a market economy. Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China has fully implemented its WTO trading rights obligations,
- whether China has removed restrictions on foreign investments on industries where such restrictions do not exist in the United States,
- whether, based on surveys of U.S. producers, China is directly or indirectly forcing technology transfer for companies investing in China, and
- whether China is in full compliance with its TRIMs obligations.

4. <u>The extent of government ownership or control of the means of production</u>

While China's ownership of the means of production has declined, it remains very high. As reported in the Chinese press, state-owned enterprises (SOEs) currently account for about 50% of the total industrial output and over two-thirds of the industrial loans.[31] Moreover, government ownership or control extends below the central government level to the provinces and local governments. And, notwithstanding that the number of SOEs has declined, China still views the SOEs as essential entities in its economic structure, as noted by the Economist:

> For China's top leadership .... SOE reform is not about profits, and certainly not about privatisation. The aim is not to reduce the state's control over key sectors of the economy, but to make that control more effective. If a stockmarket listing of the sale of a stake can bring in technology, private-sector expertise and discipline, well and good. But the government intends to remain in control.[32]

Government ownership or control of the means of production is potentially highly-distortive of market conditions and U.S.-China trade as such entities may operate other than on commercial considerations to achieve political and other non-commercial objectives.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

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30 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 87. *See also* Kathryn Kranhold, *China's Price for Market Entry: Give Us Your Technology, Too*, WALL STREET JOURNAL, February 26, 2004, p. 1.

31 *Restructuring of SOEs Brings Opportunities to the Development of Private Enterprises*, Zheng Quan Shi Bao, available at http://www.tianqiang.com.cn/admin/zxk_Manage/Html/gzdx/20040205103936.htm (Feb. 5, 2004).

32 *We are the champions*, THE ECONOMIST, March 20, 2004.

- whether China's extent of government ownership or control of the means of production (including central, provincial and local governments) is at or below the average for OECD countries.

5. **<u>The extent of government control over the allocation of resources and over the price and output decisions of enterprises</u>**

It is understood that there is "guidance" provided on prices for a wide range of products and that the government sets prices on certain major inputs (*e.g.*, energy pricing). Specifically, Annex 4 of China's Protocol of Accession to the WTO reviews a variety of products which are subject to price controls (tobacco, edible salt, natural gas, various pharmaceuticals, various public utilities, postal and telecommunications charges) while other products are subject to government guidance on pricing (grain, vegetable oil, processed oil, fertilizer, cotton, transport services, professional services, and other services).

Moreover, the Chinese Government has been using the banking system to funnel moneys to and away from industries which effectively controls a critical resource – capital – and affects output decisions at least on the macro level. The four state-owned banks account for 56% of total bank assets.[33] All banks are subject to control through the China Banking Regulatory Commission and capital adequacy requirements[34]. This goes beyond the control of interest rates by central banks in most countries. This gives the government control over almost all enterprises needing loans. Recently, Premier Wen Jiabao said he wanted lending to steel, cement, aluminum, and other industries to slow. As reported by the state run China Central Television on April 27, 2004, the State Council reduced the percentage of debt companies may use in funding steel, cement, aluminum and real estate projects.[35] With the power of the purse, the Chinese Government can select favored or disfavored industries to guide the economy in the direction it wants.

Thus, as these recent government efforts to reduce inflationary pressures show, the government continues to exert considerable control on allocation of financial resources from the banking sector. While the Chinese government may feel the need to interfere in the operation of markets for a variety of governmental or societal objectives, there is no question but that such interference distorts the operation of the Chinese market and U.S.-China trade flows.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

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33 Bloomberg.com, available at http://quote.bloomberg.com/apps/news?pid=10000080&sid=a9ej33KkD1Bc&refer=asia

34 China Business Strategy Daily News, April 12, 2004, available at http://www.china-ready.com/news/April2004/ChinaLiftsCapitalAdequacyRatiosForBanksAgain041204.htm

35 Bloomberg.com, available at http://quote.bloomberg.com/apps/news?pid=10000080&sid=a9ej33KkD1Bc&refer=asia.

- whether China's extent of government control over the allocation of resources and over the price and output decisions of enterprises is at or below the average for OECD countries.

6. Such other factors as the Department of Commerce may consider relevant

We would suggest that the following additional factors are relevant to a consideration of whether China has reformed its economy to an extent that would permit the country to be treated as a market economy.

a. Effective enforcement of intellectual property rights

With the importance of information technology (IT) to modern industries, the failure of China to effectively enforce intellectual property rights is highly distortive of U.S.-China trade. With estimates for software, CDs, DVDs and other products running as high as 95% counterfeit, failure to enforce can provide dramatic losses of export earnings for U.S. companies, reduce costs for Chinese companies and result in other distortions in the competitive landscape.

USTR reports that IPR infringement is endemic in China's economy, affecting products, brands and technologies across a wide range of industries, including "films, music, publishing, software, pharmaceuticals, chemicals, information technology, consumer goods, electrical equipment, automotive parts and industrial products."[36] Moreover, in July 2003, the State Council's Development Research Center estimated that the market value of counterfeit goods in China was between $19 billion and $24 billion, "which translates into enormous losses for IPR rights holders."[37] Estimated annual losses to U.S. interests due to piracy of copyrighted materials is over $1.8 billion.[38]

Similarly, industries often expend huge sums to develop new products or create innovative designs or more efficient production processes. Where such intellectual property interests are stolen, false competitiveness is developed by those using the stolen IP interests and highly-competitive companies lose sales and see investments undermined.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China's enforcement of intellectual property rights results in a level of piracy/counterfeit goods being present in the market which is at or below the average for OECD countries, as well as

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36 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 73.

37 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 73.

38 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 73.

- whether effective enforcement exists for claims against other forms of IP rights losses.

b. <u>Elimination of limitations on trading rights for all products and controls on pricing of goods and services</u>

China maintained, within the context of its accession protocol, the right to limit who could import and export certain goods. These limitations are in addition to the right to fix prices or provide pricing guidance reviewed above. Specifically, Annex 2A1 of China's Protocol of Accession list products subject to state trading on imports into China (grain, vegetable oil, sugar, tobacco, crude oil, processed oil, chemical fertilizers). Annex 2A2 to the Protocol lists products subject to continued state trading on exports (tea, rice, corn, soy beans, tungsten ore, ammonium paratungstates, tungstate products, coal, crude oil, processed oil, silk, unbleached silk, cotton, cotton yarn, woven fabrics of cotton, antimony ores, antimony oxide, antimony products, silver) and Annex 2B lists products subject to designated trading for a period of time (natural rubber, timber, plywood, wool, acrylic, and steel). While such controls are permitted under the WTO accession protocol, they nevertheless present the potential for significant distortions on an economy-wide basis or in particular segments of the economy depending on the goods involved.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China has eliminated state trading and designated trading for all goods.

c. <u>Clean up of banking sector and elimination of all government interference/control on the banking activities within China</u>

China's banks are awash in bad debt and most are described as technically bankrupt as nearly a half trillion dollars of loans to Chinese businesses (including many state-owned or state-invested business) have not been repaid. A recent report in the Washington Post indicated that "China's banks are carrying bad loans estimated by private economists to total $500 billion."[39] Business Week notes that: "The banks are in bad shape .... big problems remain. Standard & Poor's estimates that bad debt could be as high as 45% of outstanding loans, so a full bailout could cost about $600 billion, or some 40% of last year's [2003] GDP."[40]

Reform of the banking system in China has been difficult, in part due to the tension between their traditional functions and the effort to transition to a more market-based system.

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[39] Peter S. Goodman, *Loans Feed Inflation in China, Regulators Say*, Washington Post, March 12, 2004, at E01.

[40] Worrying About China, BusinessWeek online, January 19, 2004.

> China's banks have historically functioned not as profit-makers but as arms of the state, lending to government-owned companies to maintain jobs and support national public works projects such as dams, bridges and airports. ... In principle, the government now wants them to lend on purely commercial terms, cutting off bankrupt state firms ands maximizing profit. But some officials also want the banks to ensure the flow of credit to cherished industries while propping up companies that are major providers of jobs.[41]

Until the banking sector is reformed and until the Chinese businesses with large outstanding debts are required to pay the debts back or go through bankruptcy, the system is highly distortive internally and in terms of U.S.-China trade.

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for whether China's economy is properly categorized as a market economy:

- whether Chinese banks and companies are operating on commercial principles including making loans based on commercial considerations reflecting the risk of a particular enterprise, and
- whether the level of bad debts by Chinese companies is at or below the average for OECD countries.

d. <u>Compliance with WTO subsidy obligations contained in China's protocol of accession and Working Party Report</u>

China, pursuant to its protocol of accession, was to eliminate all export subsidies (industrial and agricultural goods) upon accession. This has not happened, as is reflected in the USTR's 2002 and 2003 China WTO Compliance Reports, which indicated that China continued to allow export subsidies for agricultural products, particularly corn and cotton.[42] In addition, USTR has noted the concern of U.S. industry that China has continued to grant export subsidies to industrial products, such as high technology electronics, biomedicine, new materials and integrated circuits,[43] textiles, steel, petrochemical, machinery and copper and other non-ferrous metals industries.[44] In the 2004 National Trade Estimate Report on Foreign Trade Barriers, USTR states that "U.S. industry has alleged that subsidization is a key reason that Chinese exports are undercutting prices in the United States and gaining market share."[45]

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[41] Peter S. Goodman, *Loans Feed Inflation in China, Regulators Say*, Washington Post, March 12, 2004, at E01.

[42] *See* USTR, *2002 Report To Congress On China's WTO Compliance*, at 33 (December 11, 2002); USTR, *2003 Report To Congress On China's WTO Compliance*, at 48 (December 11, 2003).

[43] *See* USTR, *2003 National Trade Estimate Report on Foreign Trade Barriers* at 58.

[44] *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 72.

[45] *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 72.

USTR notes that export subsidies in China are difficult to identify and quantify because they are often the result of internal administrative measures and not publicized.[46] Moreover, they can take any number of forms, including mechanisms such as credit allocations, low-interest loans, or guaranteed provision of energy, raw materials or labor supplies.[47]

It is understood that China's value-added tax (VAT) and other taxes on imported equipment are not required where a facility is being built solely for export. At the WTO, China confirmed that it uses its tax laws to encourage the formation of wholly foreign-owned enterprises that are export-oriented.[48] These would appear to constitute export subsidies barred by the WTO protocol. The Department has found such types of tax programs to be export subsidies where they provided a benefit contingent upon exports.[49]

Nor, as the Department is aware, has China provided the subsidy notifications required by its accession agreement, making it difficult for trading partners to determine the extent of export and other subsidies being provided.[50] In its 2004 Subsidies Enforcement Report, the Department noted that:

> In 2003, China again did not submit any information about its subsidy programs to the Subsidies Committee as required by Article 25 of the Subsidies Agreement. This is the second year that China has not made the required annual subsidy notification. The obligation to notify subsidies is a key obligation of the Subsidies Agreement, because it provides other WTO Members with the ability to evaluate another Member's subsidy programs and assess compliance with its Subsidies Agreement obligations.[51]

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

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[46] *Id.*

[47] *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 72; USTR, *2003 National Trade Estimate Report on Foreign Trade Barriers* at 58.

[48] *See* WTO Committee on Subsidies and Countervailing Measures, *Chair's Report to the Council for Trade in Goods on Transitional Review of China*, G/SCM/111 (4 November 2003) at 5. Specifically, China exempts wholly foreign-owned enterprises that are export-oriented from paying income tax for a certain period of time, which is followed by an additional period during which the enterprise is entitled to a 50 percent rebate of income tax. Enterprises located in special economic zones, or economic and technology development zones, or any other exporting enterprises that already enjoyed an income tax rate of 15 per cent, would pay income tax at the rate of 10 per cent if they also met certain requirements.

[49] *See, e.g., Oil Country Tubular Goods from Korea*, 49 Fed. Reg. 46776 (Nov. 28, 1984).

[50] *See* USTR & Dept. of Commerce, *Subsidies Enforcement Annual Report to the Congress* (Feb. 2004) at 23. WTO Committee on Subsidies and Countervailing Measures, *Chair's Report to the Council for Trade in Goods on Transitional Review of China*, G/SCM/111 (4 November 2003) at 3.

[51] *See* USTR & Dept. of Commerce, *Subsidies Enforcement Annual Report to the Congress* (Feb. 2004) at 23.

- whether China is in full compliance with its subsidy obligations undertaken as part of its WTO accession.

e. **State-owned and state invested enterprises**

Significant parts of the Chinese economy remain state-owned or state-invested. While Article XVII of GATT 1994 permits state trading enterprises, the lack of transparency on state-owned and state-invested enterprises makes it impossible to determine whether they are behaving on market principles and for commercial considerations. Hence, major distortions are possible by the continued large share of GDP accounted for by state-owned and state-invested enterprises.

A recent article in the Economist observed that state-owned enterprises (SOEs) in China are still dominant economic entities.

> The contrast between old and new in the state sector is at its starkest in China's north-eastern "rustbelt", where state-owned enterprises (SOEs) generate 70% of GDP. But it exists throughout the country, and shows how much further SOE reform has to go.
>
> It is no exaggeration to say that China's economic future depends on such reform. In 2002, the state controlled half of industrial output, and SOEs still account for 35% of urban employment, despite having halved their workforce in the past 12 years. Virtually all of China's heavy industry and much of its technology is in state hands. Half of all bank loans go to SOEs. This crowds out the private sector, China's growth engine, and threatens the entire financial system, because most of those loans will never be repaid.[52]

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether the level of state-owned and state-invested enterprises in China is at or below the average for OECD countries.

f. **Discrimination against foreign goods**

As exhibited by the pending WTO challenge of China's discriminatory VAT tax on imported semiconductors, China's interference in the market includes disparate treatment for domestic and foreign goods inconsistent with WTO obligations. Such discrimination is highly distortive in the market of China and in U.S.-China trade.

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52 *We are the champions*, THE ECONOMIST, March 20, 2004.

In its 2003 China WTO Compliance Report, USTR noted that although China agreed to assume the obligations of national treatment, China did not appear to have observed national treatment requirements in all areas. For example, USTR said that "several U.S. industries reported that China continued to apply the value-added tax (VAT) in a manner that unfairly discriminates between imported and domestic goods, both through official measures and on an ad hoc basis."[53] USTR also noted that "it appeared that China applied sanitary and phyto-sanitary measures in a discriminatory manner in both 2002 and 2003.[54] Further, in the 2004 NTE report, USTR said China was using border trade policies to provide preferential treatment for Russian timber imports, "to the detriment of U.S. timber exporters."[55]

Accordingly, we believe that the Commerce Department should use as one of its benchmarks for determining whether China's economy is properly categorized as a market economy:

- whether China has eliminated all forms of discrimination against foreign goods that are not expressly permitted by the WTO.

NOTIFICATION OF INTENT TO TESTIFY AT HEARING

Pursuant to the May 3, 2004 Federal Register notice, 69 Fed. Reg. 24132-33, we hereby notify the Department of our intent to testify at the public hearing scheduled for June 3, 2004. Terence P. Stewart will testify on behalf of Stewart and Stewart.

Respectfully submitted,

Terence P. Stewart
STEWART AND STEWART

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53 USTR, *2003 Report To Congress On China's WTO Compliance*, at 31 (December 11, 2003).

54 *Id.*

55 *See* USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers* at 63.

Recommended Benchmarks that the United States use to compare China's performance on many factors

We believe that the Commerce Department should use the following benchmarks for determining whether China's economy is properly categorized as a market economy:

1. Currency convertibility	• whether China has dismantled the currency exchange/controls and has obtained a freely floating currency. • At a minimum, the currency should be valued at a level that approximates the underlying value vis-à-vis the U.S. dollar.
2. Wages freely set	• whether China has fully implemented ILO core labor standards (and the related topic of dramatic improvement in its record on human rights).
3. Joint ventures and other investments	• whether China has fully implemented its WTO trading rights obligations, • whether China has removed restrictions on foreign investments on industries where such restrictions do not exist in the United States, • whether, based on surveys of U.S. producers, China is directly or indirectly forcing technology transfer for companies investing in China, and • whether China is in full compliance with its TRIMs obligations.
4. The extent of government ownership or control of the means of production	• whether China's extent of government ownership or control of the means of production (including central, provincial and local governments) is at or below the average for OECD countries.
5. The extent of government control over the allocation of resources and over the price and output decisions of enterprises	• whether China's extent of government control over the allocation of resources and over the price and output decisions of enterprises is at or below the average for OECD countries.
6. Such other factors as the Department of Commerce may consider relevant	• whether China's enforcement of intellectual property rights results in a level of piracy/counterfeit goods being present in the market which is at or below the average for OECD countries, as well as
a. Effective enforcement of intellectual property rights	• whether effective enforcement exists for claims against other forms of IP rights losses.
b. Elimination of limitations on trading rights for all products and controls on pricing of goods and services	• whether China has eliminated state trading and designated trading for all goods.

c. Clean up of banking sector and elimination of all government interference/control on the banking activities within China	• whether Chinese banks and companies are operating on commercial principles including making loans based on commercial considerations reflecting the risk of a particular enterprise, and • whether the level of bad debts by Chinese companies is at or below the average for OECD countries.
d. Compliance with WTO subsidy obligations contained in China's protocol of accession and Working Party Report	• whether China is in full compliance with its subsidy obligations undertaken as part of its WTO accession
e. State-owned and state invested enterprises	• whether the level of state-owned and state-invested enterprises in China is at or below the average for OECD countries.
f. Discrimination against foreign goods	• whether China has eliminated all forms of discrimination against foreign goods that are not expressly permitted by the WTO.