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MEMORANDUM FOR: Robert S. LaRussa
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THROUGH: David Mueller
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SUBJECT: Antidumping Investigation of Certain Small Diameter Carbon and Alloy Seamless Standard line and Pressure Pipe from the Czech Republic: Non-Market Economy ("NME") Country Status

SUMMARY

Since its emergence as an independent, democratic state, the Czech Republic has successfully made the transition to a market economy country. The Czech currency is now fully convertible. Wages in the Czech Republic are market-based, largely determined by free bargaining between labor and management. Trade has been liberalized and tariffs reduced, and the Czech government is actively promoting foreign investment and business ventures. Industry, agriculture and services have all been privatized, and the power to make decisions related to the allocation of resources, and over pricing and output decisions, now rests with the private sector. Based on the preponderance of evidence related to economic reforms in the Czech Republic, analyzed as required under section 771(18)(B) of the Tariff Act of 1930, as amended ("the Act"), the Department should revoke the Czech Republic's NME-country status, effective January 1, 1998.

BACKGROUND

On July 23, 1999, we received a letter from the Government of the Czech Republic requesting revocation of its NME-country status in the context of the antidumping duty investigation of certain small diameter carbon and alloy seamless standard line and pressure pipe. In light of this request, on August 5, 1999, we initiated a formal inquiry into the possible revocation of the Czech Republic's NME status under section 771(18)(A) of the Act.

We sent letters to the Embassy of the Czech Republic, the petitioners[1], and counsel for Nova Hut a.s., the sole respondent in this investigation, requesting that they submit any facts and information relevant to the Department's consideration of this issue. We specifically asked interested parties to address the six factors in section 771(18)(B) of the Act that the Department must consider in making its determination.

On August 16, 1999, we received facts and information relevant to this issue from the Embassy of the Czech Republic and the petitioners. The Government of the Czech Republic maintains that its NME status should be revoked for the following reasons:

- The Czech koruna is freely convertible for both domestic and current account transactions.
- Wages in the Czech Republic are now largely determined by the interplay of negotiation and market forces.
- Foreign entities may establish joint ventures or wholly-owned companies in the Czech Republic.
- The Czech Republic moved rapidly to privatize its economy. Privatized firms account for approximately 75 percent of total economic output.
- Resource allocation and price and output decisions are controlled primarily by market forces, not government direction.
- The Czech Republic maintains an open trade policy with relatively low Most Favored Nation ("MFN") tariffs and other market-based policies.
- The Czech Republic's membership in international organizations underscores its transformation into a market economy.
- In comparison to other countries, the Czech Republic is a market economy, and is more market-oriented than other former centrally planned economies.

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[1] Gulf States Tube, a Division of Vision Metals, Inc.; Koppel Steel Corporation; Sharon Tube Corporation; USS/Kobe Steel Corporation; and U.S. Steel Group, a unit of USX Corporation.

The petitioners maintain that the NME status should not be revoked for the following reasons:

- Although the Czech Republic's law permits joint ventures and foreign investment, foreign investors continue to face problems in asserting their rights as owners.
- The Czech Government still has substantial ownership and control over the means of production.
- The Government of the Czech Republic continues to retain authority to set prices.

APPLICABLE STATUTE

In making a NME-country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department take into account: (1) the extent to which the currency of the foreign country is convertible into the currency of other countries; (2) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management; (3) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country; (4) the extent of government ownership or control of the means of production; (5) the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and (6) such other factors as the administrating authority considers appropriate.

OVERVIEW OF ECONOMIC REFORMS

Following the "velvet revolution" of 1989 (the peaceful removal of the Communist Party from power), Czechoslovakia embarked on an economic reform program intended to create a full-fledged market economy, reintegrated with Western Europe. The government quickly ruled out a "mixed economy," in which State management efforts would dictate activities and outcomes in the "non-market" part of the economy and the profit-maximizing initiatives of private economic agents would dictate activities and outcomes in the "market" part. The reform leaders believed that the contradictions inherent in such a mixed economy would pose serious macroeconomic management and coordination problems and would generate costs that would far outweigh any possible benefits.[2]

As a result, Czechoslovakia quickly liberalized prices and trade and implemented a comprehensive national privatization program to transfer the means of production back into private hands as quickly as possible, wanting to achieve a ratio of state property to private property similar to that in fully developed market economies. The government passed a law on private enterprise allowing private sector participation in virtually any economic activity,

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[2] Zecchini, Salvatore, ed. Lessons from the Economic Transition: Central and Eastern Europe in the 1990s. Boston: Kluwer Academic, 1997, p. 9.

abolished the monopoly of foreign trade corporations on external trade, significantly reduced average tariff levels, and amended the joint venture law to allow for 100 percent foreign participation. A two-tier banking system was created by breaking up the state monobank, leaving an independent central bank to formulate and implement monetary and exchange rate policies. The government also began the arduous task of rebuilding the necessary legal and institutional infrastructure of a market economy.[3] The Czechoslovaks managed the initial phase of the transition process quite well, employing tight fiscal and monetary policies, a pegged exchange rate as a nominal anchor for the economy, and a "voucher privatization" program that gave everyone a stake in the process. By the beginning of 1993, prices and the exchange rate had stabilized, and the drop in aggregate output had been arrested.[4]

It was at that point, at the beginning of 1993, that the Czech-Slovak Federation dissolved. Nevertheless, reforms continued in the newly established Czech Republic, which in 1995 became the first post-communist member of the Organization for Co-Operation and Development (OECD).[5] Such membership requires a demonstrated commitment to an open market economy, democratic pluralism and respect for human rights. By 1998, (1) the privatization of Czech agriculture was complete and that of industry nearly complete, as the government continued to sell, or planned to sell, residual holdings in enterprises that previously could not find a buyer and in a limited number of "strategic enterprises"; (2) remaining price controls--which cover utilities, [illegible] and capital accounts; (4) budgetary subsidies had been reduced; and (5) bankruptcy laws had been strengthened and enterprise budget constraints hardened.

The Czech Republic's reforms have been neither *ad hoc* nor incremental in nature. Instead, these reforms have been part of a continuing, systematic and comprehensive effort by the Czech Government to build a market economy and democratic state. The following section presents a discussion of each of the six statutory factors that the Department considered in determining whether the Czech Republic's NME-country status under the U.S. antidumping ("AD") law should be revoked at this time.

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[3] Aghevli, Bijan B., Borensztein, Eduardo and Tessa van der Willigen. Stabilization and Structural Reform in the Czech and Slovak Federal Republic: First Stage (Occasional paper No. 9). Washington, D.C.: International Monetary Fund, 1992, p. 4.

[4] Zecchini, Salvatore, ed. Lessons from the Economic Transition: Central and Eastern Europe in the 1990s. Boston: Kluwer Academic, 1997, pp. 12-15.

[5] [illegible] 1998 [illegible]

SECTION 771(18)(B) FACTORS

(1) *The extent to which the currency of the foreign country is convertible into the currency of other countries.*

The Czech koruna ("koruna") was pegged daily to a basket of five currencies up until July 1994, when the basket was reduced to the German mark (65 percent) and the U.S. dollar (35 percent).[6] The Czech National Bank ("CNB") maintained the pegged rate within a target zone of ± 7.5%. Exchange controls were put in place to ensure exchange rate stability, which the government relied on as a nominal anchor for the economy.

The exchange controls on current account transactions were gradually lifted and, in 1995, by amendment to the Foreign Exchange Act, the Czech Republic brought its exchange rate regime into compliance with Article VIII of the International Monetary Fund's Articles of Agreement. These IMF obligations include (1) the avoidance of discriminatory currency practices and restrictions on trade-related payments; and (2) the convertibility of foreign-held balances. As a result, the koruna became fully convertible for current account purposes.[7] Individuals and firms (domestic and foreign) in the Czech Republic can maintain foreign exchange ("FOREX") accounts without prior government approval and no longer have to surrender their export earnings or other FOREX receipts to banks. The 1995 amendments to the Foreign Exchange Act also eliminated many controls over capital account transactions, liberalizing direct investment and the purchase of real estate abroad, and the purchase by residents of foreign securities.

The Czech Republic soon felt the effects of the increased convertibility of the koruna. In 1997, the exchange-rate turmoil in Asia and twin fiscal and current account deficits combined to exert significant downward pressure on the koruna. Despite massive intervention by the CNB and a significant increase in interest rates, the CNB was forced to abandon the peg and let supply and demand forces in the foreign exchange market determine the value of the koruna. The koruna promptly lost about ten percent of its value and then quickly stabilized. The CNB will intervene in the market when necessary to smooth large, intra-day swings in the deutsche mark/koruna rate.

(2) *The extent to which wage rates in the foreign country are determined by free bargaining between labor and management.*

The Czech Republic relies on collective bargaining (a "tripartite" agreement between the government, trade unions and employer associations) to determine wage rates. Section 112 of

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[6] "Czech Republic-Koruna." Euromoney (special volume: "Guide to Emerging Currencies"), June 1995.

[7] Dedek, Oldrich. "Currency Convertibility and Exchange-Rate Policies in the Czech Republic." Russian & East European Finance and Trade, May/June 1997, p. 46.

the Labor Code (Act No. 1/1992 Coll.) provides for such collective bargaining, which determines wages in the public services sector as well as in most large companies.[8] Czech enterprises are represented in the collective bargaining process by two large nationwide organizations: the Confederation of Employers' and Entrepreneurial Unions (1.8 million members) and the Union of Industry and Transport (.9 million members). There are also several smaller associations that deal with the needs of small and medium enterprises. Czech workers are represented by two large trade union associations: the Czech and Moravian Chamber of Trade Unions (34 unions and 2.3 million members) and the Confederation Of Arts and Culture (eight unions and 138,000 members). The right of Czech workers to unionize is protected by law. They are free to form and join unions of their own choosing without prior government authorization. Currently, two-thirds of the workers are members of some labor organization, although the overall number of union members has fallen somewhat since 1991. All workers are guaranteed the right to strike once mediation efforts have been exhausted, except workers in sensitive positions (e.g., nuclear power plant operators, military, and police). Recent public sector wage controls did result in strikes by the rail workers and health workers, although significant labor unrest in the Czech Republic remains rare, particularly in the private sector.[9] Employers must give written notice of termination at least two months in advance and specify the reasons for the layoff or dismissal. Employers must satisfy the Public Employment Service and the unions that employment of a terminated worker is not possible elsewhere in the firm and must actively assist in the terminated worker's job search. Workers can give notice at any time for any reason, and there are no government-imposed restrictions on national labor mobility. Even under the old Communist regime, Czech workers enjoyed a degree of mobility unseen in other formerly planned economies.[10]

The tripartite negotiations are multi-level and can take place at the national, industry ("branch"), enterprise or even plant level. Enterprise and industry-level agreements are explicitly made part of law, and are binding on lower-level agreements. Wages in the Czech Republic are set primarily at the enterprise level, and there were 8,733 such agreements in 1995. The Ministry of Labor and Social Affairs can administratively extend the provisions of collective agreements to a union or employer not covered, although the number of beneficiaries of such extensions is not large.[11]

The tripartite wage bargaining process in the Czech Republic, however, does not preclude

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[8] Economist Intelligence Unit. Country Profile: Czech Republic. December 1998, p. 12.

[9] U.S. Department of Commerce, International Trade Administration. Country Commercial Guide FY 1999: Czech Republic. 1999.

[10] Organization for Economic Cooperation and Development (Center for Cooperation with the Economies in Transition). Review of the Labor Market in the Czech Republic. 1995, p. 51.

[11] Organization for Economic Cooperation and Development. Economic Surveys: Czech Republic 1998. 1998, p. 89.

the unilateral imposition by the government of wage controls from time to time to dampen inflationary expectations and reduce macroeconomic imbalances. For example, during 1991-94, the government imposed mandatory wage-setting guidelines, which specified minimum and maximum wage increases and fines for non-compliance. And in 1997, although the government by then had assumed a less active role in wage setting, public sector wages were frozen and the government implored the private sector to exercise wage restraint after a period of unsustainably fast wage growth that was increasing real wages and reducing the international competitiveness of Czech exports.

(3) *The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.*

Foreign direct investment ("FDI") is governed by the Czech Commercial Code ("the Code"), under which foreigners are entitled to establish and own private business enterprises and operate them under the same conditions, subject to the same tax codes, rules and regulations, as their domestic counterparts. Foreign direct investments are not screened, with the exception of a few sensitive industries, *e.g.*, petrochemicals, telecommunications and brewing, where political resistance has been high. Foreign investors can, as individuals or business entities, establish sole proprietorships, joint ventures, joint-stock companies, limited liability companies, general and limited commercial partnerships, partnerships limited by shares, and associations.

Notwithstanding the few sensitive industries described above, all sectors of the Czech economy are open to foreign investment. Foreign businesses are not subject to performance requirements concerning the establishment, maintenance or expansion of their investments. One hundred percent foreign ownership of Czech business entities is permitted, as is 100 percent repatriation in hard currency of all post-tax profits. The government can expropriate property (domestic or foreign) only for public purposes, *e.g.*, a public works project, and only on a non-discriminatory basis and in full compliance with international law. Compensation is required when expropriation occurs. The U.S. Embassy in Prague is unaware of any expropriations that have occurred since 1989. Foreign businesses and persons cannot directly own real estate in the Czech Republic. However, foreign businesses and persons can indirectly own real estate in the Czech Republic through the establishment of legally registered Czech companies.

The openness of the Czech Republic to FDI, combined with the stable political and economic environment and the well-educated labor force, is reflected in the US$ 7.5 billion stock of FDI accumulated by the end of 1997. This cumulative FDI total placed the Czech Republic third among Eastern European countries, behind the US$ 8.4 billion in Poland and the US$ 15.4 billion in Hungary. On a per capita basis, the Czech Republic at US$ 823 ranked second only to Hungary at US$ 1,667.[12]

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[12] European Bank for Reconstruction and Development. Transition Report 1998. 1998, p. 81.

While FDI flows into the Czech Republic are significant, Czech attitudes toward foreign investors and their investments have been somewhat ambivalent at times. In the past, rather than actively promoting FDI using a broad, generalized program of incentives, the Czech government offered investment incentives only on a limited, case-by-case basis, and often only to large investors. Potential foreign investors faced problems with (1) what often was inadequate information on the ownership and financial condition of target companies; (2) recourse to the court system; (3) inadequate enforcement of their intellectual property rights; (4) non-transparent bidding processes; (5) inefficiencies in the government administrative process; (6) high corporate and employment taxes; and (7) changes in the external tariff regime (brought about by the Czech Republic's European Union ("EU") Association Agreement) that favored EU goods.[13]

Recognizing that more FDI is needed to promote industrial restructuring and increase the efficiency and competitiveness of Czech industry, the Czech government in April 1998 formally adopted a broad program of incentives to actively promote FDI. Despite the fact that the qualifying investment level initially was quite high at $25 million, and that there were no incentives for secondary investments, the package was widely seen as a positive first step that is

(4) *The extent of government ownership or control of the means of production.*

Privatization and restitution efforts began in Czechoslovakia in 1990 and continued in the Czech Republic after the breakup of the Federation in 1993. These privatization and restitution efforts encompassed land and other real estate (urban and rural), banks, farms, industrial enterprises, and small businesses (primarily service and retail establishments). The government effected transfer of these properties and assets by one of following five means: (1) restitution (i.e., the return of property that was illegally confiscated without compensation); (2) public

"transformation" of agricultural collectives, which were user-based, into owner-based co-operatives; and (5) free transfer to municipalities. Restitution was not limited to Czech citizens and covered all types of property (land, housing, farms, forests and enterprises) and, along with voucher privatization, ensured that a large segment of the population would have a stake in the new economic and political order. The property transfers to municipalities (several thousand in total) involved such things as apartment buildings; land; sewer and water systems; and transit systems. The extent of the subsequent sale of these properties by the municipalities under the small- and large-enterprise restitution and privatization programs (discussed below) is not clear. The vast majority and most valuable of the companies (more than 85 percent of the value transferred) were transformed into joint-stock companies.

[13] U.S. Department of Commerce, International Trade Administration. Country Commercial Guide FY 1999: Czech Republic. 1999.

[14] Id.

These efforts would have had little meaning without the concurrent establishment and protection of basic private property rights. The government therefore passed many laws governing the transfer of state assets into private hands (*e.g.*, the Small- and Large-Scale Restitution Acts, Law Nos. 403/90 and 87/91, respectively, and the Small- and Large-Enterprise--or "small- and large-scale"--Privatization Acts, Law Nos. 427/90 and 92/91, respectively).[15] Czechoslovak Law No. 23-91, which implemented the Council of Europe Provisions, recognized the right to own land as a basic right. Law No. 23-91 also protects private, collective and State ownership, and a 1992 amendment to the 1964 Civil Code abolished the preeminence of State ownership that had previously existed.[16]

Although the data are imprecise and the numbers are sketchy, roughly 100,000 properties in the whole of Czechoslovakia were returned to their original owners or heirs. Approximately 20,000 of these were small businesses/properties--mostly family-run rental houses, shops, restaurants and pubs–and the rest were pieces of real estate.[17] Of these 20,000 small businesses/properties, perhaps 3,000 were Slovak and 17,000 Czech.[18] In many cases, the original owners or their heirs had remained attached to the property in some manner, and it was recognized that auctioning the properties in these cases would be problematic. Small businesses that went unclaimed were auctioned off under a small-enterprise privatization program, beginning in February of 1991 and ending in early 1993. In this program, buyers made their bids over several rounds. Only Czechoslovak citizens could bid in the first round. However, subsequent bidding rounds were open to foreigners, but only if they had permanent residency status. Eventually, under this program, over 30,000 small enterprises were privatized (sold or leased[19]) for more than 45 billion Czechoslovak koruna.[20] More than 20,000 of these were Czech

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[15] Zatkalíková, Anna. "Privatizing the Slovak Economy: Legislative Framework and Development." NATO Colloquium. 1995. Available: http://www.nato.int/docu/colloq/1995/95-14.htm

[16] Strong, Louise A., Thomas A. Reiner, and Janusz Szyrmer. Transitions in Land and Housing: Bulgaria, the Czech Republic and Poland, New York: St. Martin's Press, 1996, p. 95.

[17] Organization for Economic Co-operation and Development. Economic Surveys: The Czech Republic 1998. 1998, p. 50.

[18] Zatkalíková, Anna. "Privatizing the Slovak Economy: Legislative Framework and Development." NATO Colloquium. 1995. Available: http://www.nato.int/docu/colloq/1995/95-14.htm

[19] Organization for Economic Co-operation and Development. Economic Surveys 1994: The Czech and Slovakia Republics. 1999, p. 118.

The leased properties could be re-leased or sold at the end of the lease contract. The leases carried no special rights or privileges.

[20] Organization for Economic Co-operation and Development. Economic Surveys 1994: The Czech and Slovakia Republics. 1999, p. 33.

enterprises.[21]

Small enterprises not claimed by their owners and not sold under the small-enterprise privatization program were included in the large-enterprise privatization program. Just as with small enterprises, the government was committed to the restitution before sale of large enterprises. However, owners of many large enterprises did not qualify for restitution either because they had been compensated when their respective enterprises were nationalized, or because their enterprises were nationalized prior to 1948--the cut-off date for restitution claims. Therefore, restitution played a small role in the transfer of large enterprises. Large-enterprise privatization occurred in two waves. In the first wave, the largest share of enterprises, by value, was transferred by means of voucher privatization. The enterprises were converted into joint stock companies (sometimes several, in the case of some of the larger enterprises), and a large percentage of the shares in these companies was reserved for Czechoslovak citizens to bid on, using a voucher book purchased from the government for a nominal sum. Czechoslovak citizens could also exchange their vouchers for shares in mutual funds known as Investment Privatization Funds ("IPFs"). Enterprise shares not allocated for voucher privatization stayed with the government or were reserved for managers and workers. Voucher privatization eliminated the wealth barriers that would have precluded many, if not most, Czechoslovak citizens from participating in privatization and having a stake in the privatization process. Approximately 2,000 Czech enterprises were transferred in the two waves of voucher privatization.[22] Six million people bought vouchers and placed between 60 and 70 percent of them in IPFs over the course of the two waves. Over 400 IPFs were registered in the first wave alone.

At the end of 1995, total large-enterprise privatization by all means had generated revenues of approximately 590 billion koruna, about 50 percent of GDP at the time. Remaining state shareholdings amounted to 230 billion koruna--54 billion in enterprises that could find no buyer, and 176 billion in 56 strategic enterprises (*e.g.*, electricity and gas utilities, telecom and petrochemical companies, commercial airlines, insurance companies, coal mines, steelworks, aerospace and pharmaceutical companies, and the four largest commercial banks). These holdings in strategic and non-strategic enterprises represented roughly 20 percent of GDP at the time. The National Property Fund ("NPF") continued over time to sell its shares in non-strategic enterprises, to the point where, at the end of 1997, its shareholdings in these enterprises had dropped to under two percent of GDP and the private sector accounted for 75 percent of GDP.[23] The sale of NPF's residual shareholdings were made through brokers, without the NPF knowing

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[21] Hopps, June Gary and Denetrius S. Iatridis. Privatization in Central Europe: Perspectives and Approaches. London: Praeger, 1998, p. 63.

[22] Strong, Louise A.,Thomas A. Reiner, and Janusz Szyrmer. Transitions in Land and Housing: Bulgaria, the Czech Republic and Poland, New York: St. Martin's Press, 1996, pp. 109-110.

[23] Organization for Economic Cooperation and Development. Economic Surveys: Czech Republic 1998. 1998, p. 51.

who bought them and with the buyer not knowing who ultimately sold them.

The privatization of the government's shareholdings in strategic enterprises, which vary from 45 percent to 100 percent, is proceeding more slowly, although it is the government's stated intent to privatize its residual shareholdings in these enterprises. The slow pace of privatization of these last remaining enterprises is due to one or more of the following reasons. In some cases, such as electricity generation and distribution companies, the government simply wants to ensure an efficient market outcome, given the importance to the economy of the industry or sector in question. In other cases, such as petrochemicals, the government wants to get the most money for its assets, not wanting to repeat what it saw as the mistake of giving away the state's "crown jewels" to foreign investors. Finally, in still other cases, such as steel, the government is carefully reviewing proposals and options for addressing capacity and unemployment issues.[24] For example, Nova Hut, the steel company that is the respondent in this current investigation, is 49 percent government-owned according to the company's 1998 annual report.

The voucher scheme achieved the government's rapid privatization goals, but initially resulted in a somewhat dispersed ownership structure, despite the emergence of IPFs. IPFs sought to gain a controlling interest in as many of the most profitable enterprises as possible. However, the pool of such enterprises was relatively small, and Czech law prohibited an IPF from owning more than 20% (subsequently reduced to 11 percent) of a single company.[25] Many IPFs were therefore forced to take relatively small positions in a large number of companies, so that in 1996, on average, 75 percent of IPF stock portfolios consisted of participations representing 5 percent or less of a company's outstanding shares, and 85 percent consisted of participations representing 10 percent or less. Shareholdings were not, however, limited to IPFs. Over time, as IPFs diversified their portfolios and sold off some of their stockholdings to foreign investors, enterprise managers and employees, and other individuals, ownership concentration increased to the point where most privatized companies now have a majority or dominant owner.[26]

The ownership structure of Czech industry is complicated by the fact that three of the four largest banks, which are partly state-owned to varying degrees (the fourth was fully privatized in early 1998), own the management companies that run many of the largest IPFs. (In fact, until recent amendments to the Banking Act went into effect, banks could and did buy a controlling interest directly in an IPF.) Thus, there are nominal linkages between the government, the state-owned banks, the IPFs and the companies in which the IPFs have holdings.

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[24] The World Band and Organization for Economic Cooperation and Development. Between State and Market. 1997, p. 75.

[25] Many of the larger IPFs initially got around this requirement by establishing holding companies to which the 20% rule did not apply, but subsequent changes to Czech law made doing so much more difficult.

[26] European Bank for Reconstruction and Development. Transition Report 1998. 199, p. 162.

Land transfers into private hands and the privatization of agriculture essentially are

cooperatives, as land owners, who had retained nominal title to but not the right to use their land during Communist rule, regained user rights over their land. The significant effect of these transformations was not so much a real one as it was a legal one--although many of the people actually farming the land remained the same, the transformations reestablished meaningful private property rights and in many cases changed the relationship between land owners and land users from a social one to a legal/contractual one.[27] At the end of 1995, the State owned 10 percent of the land of the Czech Republic, with plans to sell off more than half of its holdings. Preference will be given to neighboring property owners and farmers, and only Czech citizens will qualify.[28]

(5) *The extent of government control over the allocation of resources and over the price and output decisions of enterprises.*

In 1991, before the breakup of the Federation, the vast majority of prices in Czechoslovakia were liberalized. At the end of 1997, there were price controls in the Czech Republic affecting a limited number of goods and services, primarily for household consumption, covering energy products, utilities, rents, and some public services. These controls are being gradually phased out over time. For example, in 1998, water and sewer rates were increased 11 per cent; bus fares were increased 1 per cent; housing rents were increased 25 per cent, electricity by 24 per cent, and natural gas by 27 per cent.[29] Interest rates have been fully liberalized[30] and are set by commercial banks on the basis of the discount rate and reserve requirements established by the Czech National Bank ("CNB"). The CNB conducts monetary policy independently of the government, and the CNB's main goal of maintaining the purchasing power of the koruna is set by law. The CNB has strictly adhered to a tight monetary policy that has served the Czech Republic well in dampening inflationary expectations and stabilizing the exchange rate during the transition process.[31]

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[27] Strong, Louise A., Thomas A. Reiner, and Janusz Szyrmer. Transitions in Land and Housing: Bulgaria, the Czech Republic and Poland, New York: St. Martin's Press, 1996, p. 102.

[28] Id at 110.

[29] Czech Ministry of Industry and Trade. "Survey of the Czech Economy and MIT Sectors in 1988." 1998. Available at: http://www.mpo.cz/english/b/ba/survey98.

[30] European Bank for Reconstruction and Development. Transition Report 1998. 1998, p.189.

[31] Organization for Economic Cooperation and Development. Economic Surveys: Czech Republic 1996. 1996, p. 33.

Land rights are fully transferable, except to foreigners.[32] Moreover, as discussed above, virtually all agricultural, service, and manufacturing enterprises are in private hands, and it is these hands that now allocate resources throughout the economy. This is evidenced by the increase in the number of Czech enterprises, reductions in overall employment and average firm size, inter-sectoral changes in employment and output, and the relative growth of the services sector. In 1989, in all of what was the former Czechoslovakia, there were less than 600 industrial enterprises, each averaging just over 3,000 employees. Fewer than 20,000 people worked in the legal private sector. In 1997, there were approximately 7,300 industrial enterprises in the Czech Republic employing 20 or more people; less than 30 employed 3,000 or more people; and the average number of employees per firm had dropped under 200, as the number of small and medium firms (which tend to experience higher rates of value-added, output and profit growth) increased, and the number of large firms (which tend to experience lower rates of output, value-added and profit growth) decreased. Workers are moving out of agriculture and industry and into the market services sector *(e.g.*, wholesale and retail trade, repair shops, hotel and restaurants, transport). Consequently, the share of the market services sector in GDP at the end of 1997 was

While market entry in the industrial sector has been significant, market exits have not, despite the large number of money-losing or insolvent enterprises. These enterprises, which are insolvent primarily because of their inability to cover government tax payments, bank loan repayments, and inter-firm debt, interfere with efficient resource allocation and use. Bankruptcy has not been in the past a sufficiently real threat to harden budget constraints or improve corporate governance. Many insolvent enterprises have no incentive or motivation to restructure or reorient their operations. The Czech Republic recognized these problems and has taken steps recently to increase foreign investment (see above) and strengthen its bankruptcy laws. As a result of changes to the Czech Bankruptcy Law in early 1998, (1) the definition of "insolvency" is now more encompassing and more precise; (2) procedures have been streamlined; and (3) court orders are being strictly enforced in a short, time-limited period. Consequently, the threat of bankruptcy is now much more real, as the number of court-declared bankruptcies nearly tripled in the period 1996-1998, and nearly doubled in the period 1997-1998, going from 808 in 1996, to 1,251 in 1997 and 2,022 in 1998.[34] These bankruptcies are, for the most part, concentrated among smaller-sized enterprises.

There is no indication or evidence that the government is the primary allocator of capital in the economy. In the Czech Republic, as in many Eastern European countries, corporate debt and equity markets are underdeveloped and illiquid, and industry tends to rely primarily on bank

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[32] European Bank for Reconstruction and Development. Transition Report 1998. 1998, p. 189.

[33] Economist Intelligence Unit. Country Profile: Czech Republic. December 1998, p. 16.

[34] Czech Ministry of Industry and Trade. "Survey of the Czech Economy and MIT Sectors in 1988." 1998. Available at: http://www.mpo.cz/english/b/ba/survey98.

loans for much of their capital needs. For this reason, if systematic, large-scale, non-market (state-directed) allocations of capital were occurring in the Czech Republic, they would be going through the banking system. However, the requisite government control over the banks that such allocations would require does not exist. Although it is true that the government has been slow to sell off its residual shareholdings in the banking sector, and that the government's bank policy has been geared toward easing and ensuring the orderly transition of the banking sector (carrying a significant volume of bad debt), the government's selective intervention policy does not extend to intervention in banking operations. Indeed, the government has often been criticized for its inability to exercise adequate supervisory and regulatory control over the banking sector.[35]

Current banking sector problems in the Czech Republic are due in large part to lack of sufficient competitive pressure on the largest banks, the interdependence between creditor banks and debtor enterprises, and the complex set of incentives arising out of bank-IPF-enterprise links that drive bank behavior in part. For example, banks in some cases have utilized bank-IPF-enterprise links to charge higher-than-market rates on loans to "unlinked enterprises" to cross-subsidize money-losing loans to "linked enterprises." Some banks have also resisted using NPF recapitalization funds to renew and strengthen their ability to lend to struggling but potentially profitable firms and have, instead, used the funds to support chronic money-losers that often happened to be their largest clients.[36]

In this environment, Czech banks are struggling to make themselves viable in the long run and they are succeeding, by and large, with the government's help. They have collectively demonstrated the ability to make a profit, although they suffer periodic losses and even failures from time to time, as do banks in all countries when there are economic downturns. Reserves and provisions have steadily increased over time, as have capital adequacy ratios, to the point where it is estimated that expected losses from the loan portfolio are covered for the most part by either reserves or collateral.[37] Assistance from the government, which has been granted on a limited and selective basis, has largely taken the form of bad debt consolidation, loan guarantees, and partial recapitalization of selected banks.[38]

(6) *Such other factors as the administering authority considers appropriate.*

The ongoing economic transformation process in the Czech Republic has been aided by the

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[35] The World Band and Organization for Economic Cooperation and Development. Between State and Market. 1997, p. 77.

[36] Id.

[37] Czech National Bank.

[38] The World Band and Organization for Economic Cooperation and Development. Between State and Market. 1997, p. 76.

existence of a compulsory, well-developed social security system, including health, unemployment, sick-leave and pension benefits. Employees contribute 1.1 percent of their wages for sick-leave benefits, 6.5 percent for pension benefits, and .4 percent for unemployment insurance. Employer contributions are 3.3, 19.5 and 3.2 percent, respectively.[39] Such a safety net makes it easier to absorb the social adjustment costs of restructuring and transformation, which, in turn, reduces resistance to economic reforms that must be implemented.

The Czech Republic is a founding member of the World Trade Organization ("WTO"), and has assumed all obligations and commitments that such membership requires. As a participant in the Uruguay Round of multilateral trade negotiations, the Czech Republic significantly reduced its trade-weighted average tariff rate and bound 100 percent of its industrial tariff lines, resulting in a post-Uruguay Round average tariff rate of just under four percent. The Uruguay Round helped to consolidate and give permanence to the broad range of trade reforms the Czech Republic has undertaken to date.[40]

The Czech Republic joined the OECD in 1995, which required a demonstrated commitment to an open market economy, democratic pluralism and respect for human rights. Membership also required that the Czech Republic undertake to ensure sustained economic growth and external and internal stability, to reduce obstacles to trade in goods and services, and to liberalize capital flows. The Czech Republic is also on the fast track for EU membership, having so far satisfied almost all political and economic requirements for entry into the union.

Finally, we must note the Czech Republic's vigorous embrace of democracy. The Constitution adopted in December 1992 by the national Council of the Czech Republic, and the Charter of Fundamental Rights that forms an integral part of it, established a parliamentary democracy. This democratic foundation has proved to be very successful such that the European Commission has stated: "The Czech Republic presents the characteristics of a democracy, with stable institutions guaranteeing the rule of law, human rights and respect for and protection of minorities."[41] These political reforms have helped to strengthen and expand all-important economic freedoms that underlie all market economies.

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[39] Organization for Economic Cooperation and Development. Economic Surveys: Czech Republic 1998. 1998, p. 94.

[40] Organization for Economic Co-operation and Development. Trade Policy and the Transition Process. 1996, p. 33.

[41] European Commission. "Commission Opinion on the Czech Republic's Application for Membership of the European Union." 1997.

ANALYSIS AND ASSESSMENT

Section 771(18)(B) of the Act enumerates six factors that the Department must consider in determining whether a country operates on market principles of cost or pricing structures, within the meaning of section 771(18)(A). However, the statute provides no direction or guidance with respect to the relative weight that should be placed on each factor in assessing the overall state of the economy, which implies that the Department may use discretion in its evaluation, based upon unique facts in each case. We note at the outset that each of the six statutory factors discussed is framed in terms of the *extent* of government intervention, and not in terms of absolutes, suggesting that complete *laissez faire* and a perfectly competitive market economy is not the applicable standard. We recognize, therefore, that policies and measures such as (1) on-again-off-again import surcharges; (2) government management of a limited number of "strategic enterprises" that the government does not want to privatize; (3) wage controls designed to dampen inflationary expectations; (4) industrial development policies, which often are implemented at the expense of imports and foreign investors; and (5) direct Central Bank intervention in foreign exchange markets, typically characterize the macroeconomic management of many market economy countries.

As the discussion above makes clear, the Czech Republic has made the transition to a market economy, despite the occasional slow-downs and setbacks. First, the vast majority of prices have been liberalized and are market-determined, and tariff reductions and the convertibility of the koruna on both current and capital accounts have linked Czech markets and prices to international markets. Second, the Czech Republic is open to foreign direct investment, and wages are not set arbitrarily by the government, but by the market and through a process of collective bargaining among workers, enterprises and the government. Third, privatization did not involve "half-measures," such as a large-scale devolution of control over state-owned enterprises from the central government to local governments, and the Czech Republic avoided the problems inherent with a "mixed economy." Instead, virtually all agricultural, service and manufacturing enterprises are now in private hands, and it is they, and not the government, that allocate resources throughout the economy. Labor is on the move, with large firms and heavy industry shrinking and the light manufacturing and services sectors growing, as individuals and firms struggle to find the best use for the Czech Republic's scarce resources. Finally, the Czech Republic has successfully integrated itself into the global community. It is a founding member of the WTO, it is a member of the OECD, and it is on the fast track to membership in the EU. While membership in the WTO and the OECD and integration into the world economy are not themselves dispositive of a successful transition to a market-based economy, they are nonetheless significant steps.

Despite the extensive privatization that has occurred to date, there remain problems in the Czech Republic's industrial and banking sectors, such as insolvency, weak corporate governance and bad debts, which are hindering restructuring and efficient resource allocation and use. We first note that bad debts and weak corporate governance are not problems unique to transition economies. Second, although many Czech enterprises are insolvent and losing money, many

others are solvent and profitable. On an industry wide basis, rates of return on equity are trending upward and overdue payables as a percentage of sales are trending downward.[42] In fact, industry as a whole is profitable and aggregate output is increasing,[43] and, as noted above, average employment levels and average enterprise size are falling and labor productivity and exports are increasing, as Czech enterprises have become competitive in world markets. Czech enterprises as a whole have reoriented themselves, diversifying away from large-scale, heavy industrial [illegible] to the system at large.

Finally, while the bank-IPF-enterprise links complicate the situation and arguably exacerbate these problems, there is no indication or evidence that the government is using these links--assuming it could--to exercise the type of control over enterprise operations and resource (*e.g.*, capital) allocations on a scale and to a degree contemplated by sections 771(18)(A) and (B). On the contrary, government interventions in the banking sector are focused on recapitalizing and strengthening banks (imposing more stringent requirements concerning loan classifications and loan loss provisions; limiting enterprise shareholdings; and separating a bank's commercial banking and investment banking operations to reduce the likelihood of bank-IPF-enterprise links dictating lending practices), increasing competition and foreign participation,[44] and maximizing the efficiency with which banks perform their role of financial intermediator between savers and investors. The limited and selective recapitalizations of Czech banks that have occurred to date must be viewed in this context, taking into account that bank bailouts (sometimes extensive) occur periodically throughout the world. These recapitalizations collectively are not of a sufficiently large scale or scope (relative to the economy as a whole), and banks collectively are not in such bad financial condition that the process and participants, taken as a whole and extrapolated over time, could reasonably be viewed as involving quasi-fiscal agents of the government extending "policy loans" and soft credits to industry, at interest rates set on an administrative basis. Instead, these interventions appear to be steps that are enabling the banks to assume fully the role that they must assume to promote growth and the efficient use of capital resources in the Czech economy.

RECOMMENDATION

For the reasons explained above, we recommend that the Department revoke the NME status for

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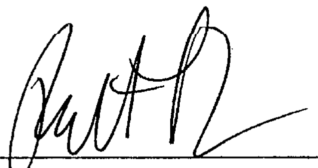
[42] Czech Ministry of Industry and Trade. "Survey of the Czech Economy and MIT Sectors in 1988." 1998. Available at: http://www.mpo.cz/english/b/ba/survey98.

[43] Organization for Economic Cooperation and Development. Economic Surveys: Czech Republic 1998. 1998, pp. 55-57.

[44] At the end of 1997, there were 50 commercial banks operating in the Czech Republic, 39 of which were either wholly or partly foreign owned.

the Czech Republic. The Czech Republic's economy operates on the basis of market principles to such an extent that the Czech Republic domestic prices can reasonably be used as a basis for calculating normal value within the meaning of the U.S. antidumping law. We therefore recommend that you revoke the Czech Republic's NME country status effective January 1, 1998.

Agree ✓ Disagree_______



Robert S. LaRussa
Assistant Secretary
for Import Administration

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Date