IS CHINA PLAYING BY THE RULES? FREE TRADE, FAIR TRADE, AND WTO COMPLIANCE

HEARING

BEFORE THE

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IS CHINA PLAYING BY THE RULES? FREE TRADE, FAIR TRADE, AND WTO COMPLIANCE

WEDNESDAY, SEPTEMBER 24, 2003

CONGRESSIONAL-EXECUTIVE
COMMISSION ON CHINA,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:20 a.m., in room SD–419, Dirksen Senate Office Building, Representative James A. Leach [Chairman of the Commission] presiding.

Also present: Senators Hagel, Thomas, Levin, and Dorgan; Representatives Bereuter, Dreier, Wolf, Pitts, Levin, Kaptur, Sherrod Brown, and Wu.

Also present: Paula Dobriansky, Under Secretary for Global Affairs, U.S. Department of State.

OPENING STATEMENT OF HON. JAMES A. LEACH, A U.S. REPRESENTATIVE FROM IOWA, CHAIRMAN, CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

Chairman LEACH. Let me bring this hearing to order. Chuck Hagel will be here briefly. Let me just make a quick opening statement.

Let me say, we have a rather profound panel on a number of the issues before us, particularly those of trade.

I just returned from a trip to the Far East and I am one that is a very strong believer in free markets when it comes to currency as well as commodities. I spoke very directly to Chinese officials in this regard.

I am a believer that one of the great skewing factors in international trade today are currency relationships, and that if you do not have a free market in currency, countries can manipulate trade to their advantage. Also, it is implicitly to the disadvantage of wealth of their own societies.

But trade advantages, definitely, they can do that. The great trauma in the U.S.-Chinese relationship is the trade imbalance, and it is something that I think this Congress is going to have to be increasingly concerned with. That is one reason for the discussion and the group of people that we have asked to address the Commission today.

Does anyone else want to make any opening comments? Yes, Sandy.

[The prepared statement of Chairman Leach appears in the appendix.]

Representative LEVIN. I just wanted to enter a statement in the record.

Representative KAPTUR. May I also ask, if we wish to submit a statement for the record, will that be permitted?

Chairman LEACH. It will absolutely be permitted, and anyone is entitled to do that.

Representative KAPTUR. Thank you.

Chairman LEACH. And to revise and extend any other remarks you have made as well.

Representative KAPTUR. Thank you.

[The prepared statement of Representative Kaptur appears in the appendix.]

STATEMENT OF HON. SANDER M. LEVIN, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative LEVIN. So I will ask the same, Mr. Chairman. I have a statement that relates to the hearing, but it also probably somewhat reflects my feelings about the Commission's annual report and the need for this Commission to be a center of activity.

Let me just say this, and the hearing, I think, will underline this. The purpose of this Commission that emanated from our debate on PNTR was to help this country both engage China and to pressure it, to put it bluntly, as it opens up, as it moves forward, as it becomes increasingly a vital part of the global economy, and indeed the global structure.

I think trying to meet both objectives means that we should be direct when we have issues with China. I think the purpose of this Commission is to focus on those issues that are basically within its purview, human rights, including worker rights, the rule of law, and the more this Commission can find a way to be both direct and also engaging China, I think, the better our relationship will be. Thank you.

[The prepared statement of Representative Levin appears in the appendix.]

Chairman LEACH. Well, I appreciate that.

Does anyone else want to make an opening comment?

[No response.]

Chairman LEACH. Let me, before beginning, also indicate that in discussions in China 3 or 4 weeks ago, we proposed that there are certain types of things that the United States and China can deal with on a different level than involved in politics or trade, and that is the subject of culture.

With the support of the National Endowment of the Arts, we are moving in the direction of developing an art and artists exchange program with China that I think is intended to underscore that, on certain levels that go beyond politics and go beyond economics, there can be respect for each other's societies, and that ought to be emphasized.

So, the Commission need not necessarily formally endorse that approach, but I think it is something that makes a lot of sense. I just want to put that on the table as well.

At this point, if there are no more opening statements, I would like to turn to our panelists. The first panel is composed of Charles Freeman, who is the Deputy Assistant U.S. Trade Representative for China, and Henry Levine, who is the Deputy Assistant Secretary of Commerce for Asia Pacific Policy.

We have before us in Mr. Freeman and Mr. Levine two distinguished public servants, and we welcome them. If Mr. Freeman is not here yet, why do we not begin then with the testimony of Mr. Levine.

STATEMENT OF HENRY A. LEVINE, DEPUTY ASSISTANT SECRETARY, ASIA PACIFIC POLICY, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Mr. LEVINE. Certainly, Mr. Chairman and members of the Commission. Thank you, first, very much for inviting me to participate in this hearing.

The Department of Commerce is committed to making sure that China plays by the rules, and we continue a very active set of efforts in that direction in coordination with our colleagues in the interagency process.

I will summarize my statement and will submit the full text to the Commission.

In fact, I recently returned from China with my boss, Assistant Secretary for Market Access and Compliance Bill Lash. On that trip, in addition to laying the groundwork for the upcoming visit of Secretary Evans, we also met with senior officials to discuss China's WTO compliance and other trade issues.

Assistant Secretary Lash repeatedly stressed the need for China to implement its WTO commitments fully and on time. I certainly do not need for the members of this Commission to rehash the statistics which underscore the high stakes involved here, whether it is China's growth, the growth of its economy, its growth as an international player in world trade, or the soaring bilateral trade deficit.

I would, however, just note that, certainly in my job day in and day out, I tend to focus on the problems in the economic relationship. I would note, though, that amidst those problems there are some positives.

I think it is worth noting that since 2001, China has been by far the fastest growing export market among our top 10 trading partners, with our exports growing something in the neighborhood of 22 percent this year between January and July. Furthermore, China continues to account, along with the United States, for a significant part of growth in the world economy, and that is also a plus.

As you know, I think in one particular area the Administration has placed much emphasis on is responding to the concerns of the U.S. manufacturing sector. Secretary Evans, in March, directed Under Secretary Aldonas and Commerce Department staff to review the issues affecting the competitiveness of U.S. manufacturing and outline a strategy for addressing them. The report on that subject will be released later in the fall.

In the course of developing this initiative, Commerce officials held 20 or so roundtables across the country. And of direct relevance to this session, I would note that during the roundtable discussions no country raised more attention as a source of concern than China.

Our manufacturers complained about rampant piracy of intellectual property, pressure to transfer technology in conjunction with

their investments, trade barriers, capital markets that are largely insulated from free market principles, and so forth.

We have also heard rising concerns more broadly about the pace and the direction of China's WTO implementation in areas such as transparency, distribution and trading rights, services, agriculture, financial services, and so forth.

To ensure that China honors its commitments and to make sure that U.S. companies can take advantage of the opportunities that are generated, we at Commerce, working closely with our fellow agencies, have adopted an aggressive, multi-pronged approach.

We will, for one thing, continue to target unfair trade practices wherever they occur. We are exploring the use of new tools to expand our trade promotion efforts with regard to China, and we are expanding our efforts to engage Chinese officials, I think, in keeping with the spirit of this Commission's report, to help make sure they get the rules right as they continue to write new laws and regulations in restructuring their economy.

One particular area of concern that I would flag, of course, is protection of intellectual property rights. We continue to have massive problems in that regard. I think China can, and must, do better in that area. We will continue to press on that issue.

One issue raised in the manufacturing roundtables, of course, was the issue of the exchange rate of the Chinese yuan. I would simply say on that that the Administration believes that currency values should be set by free market forces. Secretary Snow delivered that message, of course, to the Chinese some weeks ago.

Finally, let me just say we are continuing domestic outreach as well to prepare our companies to compete in the China market, and we continue to press the Chinese at all levels on the issue of market access and compliance. Next up for us will be the trip to China of Secretary Evans in October, where he will certainly work to ensure that U.S. companies face a level playing field in the China market.

Thank you for devoting this hearing to these issues, and I look forward to responding to your questions.

Thank you.

[The prepared statement of Mr. Levine appears in the appendix.]

Chairman LEACH. Thank you, Mr. Levine.

Mr. Freeman.

STATEMENT OF CHARLES W. FREEMAN III, DEPUTY ASSISTANT U.S. TRADE REPRESENTATIVE FOR CHINA, OFFICE OF THE U.S. TRADE REPRESENTATIVE, WASHINGTON, DC

Mr. FREEMAN. Thank you, Mr. Chairman and members of the Commission. I have a written statement which I would like to submit for the record, if I might, but would like to briefly summarize some remarks, then take questions.

Briefly speaking, it has been 21 months since China has been in the WTO. As most of you know, there were two main reasons that we were encouraging China into the WTO.

Number one, because of the market access opportunities that were likely to become available in one of the world's fastest growing markets, and certainly one of the more intriguing markets, but also to provide an independent forum at the WTO in which we

could mediate trade disputes without resorting to unilateral processes, unilateral action.

The other, sort of on a fundamental philosophical level, the reason we wanted to get China into the WTO, was really to begin to encourage China to play a greater role in international organizations that play by the rules, and in so doing to encourage China to play by the rules and, thus, to begin to implement more of a rule of law than they previously have had.

As most of you know, China has never traditionally been a place governed by the rule of law. There has always been a rule of man, as it were, or woman, as the case may be. So, this is something relatively new.

Truth be told, in terms of the 15 years that it took to get China into the WTO, the 15 years of very tough negotiations, the main thing the Administration has learned, as in the past 21 months, is that that 15 years was no accident.

It is extremely tough going in terms of negotiating with the Chinese post-accession to make sure that they actually fulfill their commitments that we spent 15 years getting them to undertake.

There have been some very notable positives in terms of China's implementation. The first year was very much devoted to a nuts-and-bolts operation in China of putting the legal regime in place to allow for WTO implementation and compliance.

And I have to say that that process was monumental in terms of the sheer number of new laws that they either promulgated, passed, or amended in order to get them up to speed with WTO implementation.

As many of us knew, year two, beginning December of last year, would be when the rubber met the road. In the last 9 months or so, we have really started to move beyond sheer nuts-and-bolts operations into actually trying to make sure that China lives up to not only their commitments in the WTO by passing the laws, but actually lives up to enforcing the laws that they have passed. Again, that has been an occasional rough row to hoe.

I will say that a lot has been going on in China in the last 6 months that is non-trade related. They have had a major leadership change. They have had a terrifying epidemic in SARS. They have had a fairly significant series of protests in Hong Kong that have, I think, altered the political landscape somewhat.

And they have gone through the general process of dislocations that any rapidly changing economy, especially an economy that has gone from a planned to more market-oriented economy. These have been challenges. They have not been excuses not to implement WTO, in our view.

And, to the extent that they have been distractions for the central government away from implementation efforts, we certainly have seen other actors in the Chinese economy step forward and try, if not to backslide on WTO commitments, to certainly be creative and think outside of the box in ways to work around WTO commitments.

In December 2002, and, again, every year for the next 12 years, I believe, the Administration publishes a report to Congress on China's WTO implementation. Last year, we noted four major areas of concern with China's implementation.

Those were related to agriculture issues, intellectual property rights, services, and transparency. Those continue to be the main areas of concern, but there has been an additional area of concern that we have noticed and that's China's use of value added tax policies to skew the competitive landscape for their own domestic companies, either by making the playing field slightly less than level for our exporters or to encourage exports of products that might otherwise not be competitive. These are significant areas, and I can get into them in detail.

Agriculture. We have made some steps forward. We have had some significant problems with China's imports of soybeans, both for genetically modified organism [GMO] reasons and for sanitary and phytosanitary [SPS] reasons. We have made some significant headway toward that, although we are not completely out of the woods yet.

In terms of soybeans, we did sell a record $1.2 billion worth of soybeans in the first 6 months of this year. That is an annual record, so we have made some progress there.

We have had problems with our implementation of tariff rate quotas for bulk agricultural commodities, and we pushed hard to get those done, again, as a result of our pressure.

I do not want us pat ourselves on the back quite yet, but we certainly have exported a record amount of cotton into China in the last 6 months. Again, we are not out of the woods with agriculture yet.

We talk extensively about the other areas of implementation. My time is up, I see. But, again, we are deeply engaged in pushing these issues forward. We are making progress. It is limited, and we are certainly frustrated at times.

We understand the frustrations of our exporters, our manufacturers, and our farmers. Our only pledge is that we will continue to work, and we do think we will continue to make progress, but it is a tough row to hoe. Thanks.

[The prepared statement of Mr. Freeman appears in the appendix.]

Chairman LEACH. Thank you, Mr. Freeman.

Let me just ask two quick questions. First, to Mr. Levine, from the Commerce Department. There is the issue of free and fair trade that all of us in American politics deal with constantly. Your office is among the principal ones posited with the fair trade mandate from the U.S. Government.

There is one free trade issue, though, that I would like to just emphasize again that I spoke to very briefly earlier. That is, free trade in currency. It strikes me that commodities are not that different from currencies.

Unless you have a free trade in currency, you have the capacity of individual governments to, to use a verb that was used earlier, and then also by Mr. Freeman, to skew the international landscape of trade.

I would just like to ask whether your office has made a particular effort to speak to the currency issue and the value of the RMB.

Mr. LEVINE. Having switched the order of our presentations, actually I will defer to Charles Freeman from USTR.

Chairman LEACH. Well, I am sorry. We will go to Mr. Freeman, but I want to ask this of the Special Trade Representatives' Office.

Mr. FREEMAN. Yes, that is me.

Chairman LEACH. Oh, that is Mr. Freeman. Yes. Go ahead. I apologize.

Mr. FREEMAN. I am sorry. I was delayed outside by the excellent security here.

Chairman LEACH. I am confused myself here. Go ahead, please.

Mr. FREEMAN. We understand the seriousness of the issue. We have heard manufacturers speak on this issue. As you know, Treasury Secretary Snow has been very active and up front with the Chinese about the importance to the United States of the currency issue.

As a general matter, the WTO is not what we would consider in the ordinary course of business a mechanism to address for exchange rate policies. There are other international organizations and multilateral organizations that do that. It is focused on commodity trade issues, generally.

That said, we certainly are taking the China currency issue very seriously and we are very deeply engaged with both Treasury and the rest of the Administration on the issue to make sure that what Secretary Snow is doing and what the President is doing is carried through.

Chairman LEACH. I appreciate that, although I do not want to allow you to simply escape the WTO, because it could be a subsidies issue under the WTO. So, it is not exactly a non-WTO issue.

Let me then turn quickly to Mr. Levine, because other people have questions, too. I am very concerned with some cultural types of issues. We have been working with the National Endowment for the Arts [NEA], with Chairman Dana Gioia, on the possibility of an artists' exchange and an art exchange, with a possible visit—and I do not know if it has been firmed up yet—of the Chinese premier to this country.

I am wondering if the Department is willing to think through the prospect of a cultural agreement at that time, and have you been thinking that through?

Mr. LEVINE. Thank you, Mr. Chairman. I believe the visit of the premier is confirmed, and I think the Chinese foreign minister, in town yesterday, in fact, made an announcement on that visit.

With regard to the Commerce Department, I would say that I am not aware that we have been looking at the cultural area and cultural agreements.

I will say that, from my career, having served in China several times and seen the cultural differences and misunderstandings, I strongly understand the importance of those kinds of activities. We certainly would be happy to talk with the other agencies involved, the State Department and others, and see what the status on that issue is.

Chairman LEACH. Very good.

Sandy.

Representative LEVIN. Thank you. Thank you for your testimony.

Let me follow up, Mr. Chairman, on your question about currency, and then I want to go on to others. Mr. Freeman, I am not sure that your answer is going to satisfy those who are concerned

because, as you know, article 15 of the General Agreement on Tariffs and Trade [GATT]—and it is in my opening statement that has been submitted for the record—paragraph 4 prohibits WTO members from using exchange action to "frustrate the intent of the provisions of GATT/WTO." That leaves open the possibility of our country using one or another mechanism, including a possible section 301 effort.

I want the Administration to know that the visit of the Secretary did not really satisfy the concerns, I think, of anybody. Indeed, that applies not only to China, but to Japan.

Japan has been using huge amounts of its currency to buy huge amounts of dollars. That is very open. The purpose of it is very clear. It has a clear trade impact and purpose, and it is not a stretch to say the same is true of the Chinese position on its currency.

So, our office has been looking at article 15.4, and provisions including section 301, and I think the Administration needs to do the same.

Let me ask you another question, and then maybe you can comment on both. The proposal that Mr. Bereuter and I put together some years ago now called for the creation of this Commission, but it also created or asked that there be created an annual review. That is covered by your testimony.

This is on page 4, I think, the transitional review mechanism [TRM]. You say there that "the first year of the TRM was marked by some misunderstanding between China and other members as to expectations of China at the TRM, but communication clearly improved. The Administration expects a smoother and more useful transitional review mechanism effort in year two."

I just want to underline for you how important we consider—I think the entire Congress considers—the effective use of that annual review.

China's admission into WTO was a much more major event than the accession of many other countries because of the size of its economy and its size overall. Many of us were not happy with the diligence, the effort that went into making that meaningful the first year.

So, quickly, let me ask you about one specific example of where China is not living up to its obligations, auto financing. The language was very clear in the agreement that was reached between China and the United States, and that meant between China and everybody else. It was part of its accession.

I do not know if you are familiar with that specific aspect. If you are, quickly comment on it. It is one example of China's failure to follow through with its commitment.

Mr. FREEMAN. Thank you, Congressman Levin. Taking your issues in turn, the Administration does not have a position currently on section 301 action, that that might or might not take place with respect to currency. I am very happy to work with your staff on comparing notes on how article 15 might be employed.

Representative LEVIN. Your offer is accepted.

Mr. FREEMAN. Very good.

In terms of the importance of the TRM, we agree that it is a very important process. One of the issues, the main problem that we

had last year with the TRM in terms of trying to make sure that China understood how important it was, was that China kept claiming that the TRM was a discriminatory process, that somehow they were being singled out for discrimination within the WTO for special examination.

What we kept saying to China is, look, you got in under very particular circumstances. Most WTO members, when they are accepted, actually have to implement commitments in order to be WTO members.

Because you are such an important and unique economy, you were allowed in simply by promising to implement these commitments. So the TRM is the WTO's way of back-checking to make sure you are living up to those commitments.

I think, over time, that became increasingly clear. By the end of last year, we actually had Vice Minister Long say to us, "The more we think about it, the more we realize this is actually a very useful exercise for us. For years we were paying Jeffrey Sachs and others to come into our economy and tell us what we needed to do to implement reforms. Now we just go to the WTO and you tell us what is wrong so we can implement it." Whether or not you actually believe that as a result they will implement it is another question, but at least we are now on a path where we have a better understanding. So, we anticipate it will be a bit smoother this year. We certainly are not giving up on the process, I will tell you that.

In terms of auto finance, again, this is something that, as you probably know, we have been very forceful with China on for quite some time. They did promise that they would set in motion a process to create a market for auto finance, and it is 21 months and we are still not there yet. I was there in June. They told us they had their regulation ready to go and that it will be ready in October. So, we are waiting for October.

Again, what we have done, is they have released draft rules on how to finance. We have commented. They have changed the rules. And one of the things that they say to us is, "Well, we are trying to get these out, but you guys will not let us."

We said, "Well, they have got to be right. You cannot just put out any auto finance regulations. They have got to actually make commercial sense." And, to date, they have not. So, we anticipate that the latest round of rules that they will be putting out will be better. Will they satisfy all of the interests of our constituencies and your constituencies? Maybe not. Maybe not. But we certainly are making progress.

Representative LEVIN. All right. Remember, the TRM, the second one, is up next month, right?

Mr. FREEMAN. Actually, what has happened is, there are 16 different meetings of the WTO subsidiary bodies. In fact, the Committee on Agriculture meets tomorrow morning in Geneva and does the TRM there.

What we have done, is we have submitted a series of questions to the Chinese. They have got a delegation from Beijing and Geneva that is there to address agricultural issues, both bilaterally and in the WTO.

Representative LEVIN. Thank you.

Chairman LEACH. Mr. Bereuter.

Representative BEREUTER. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony.

In our second panel, Gary Martin, president and CEO of the North American Export Grain Association will present his testimony. Mr. Freeman, I would hope that you would have a chance, with other members of the USTR, to look carefully at it.

It talks about the situation we face today with respect to our agricultural exports—uncertainty regarding biotech regulations, issuance of permanent safety certificates for biotech products, labeling and information requirements on meat and poultry products that increase export costs without enhancing food safety, and finally the lack of Chinese adherence to the agreement on the application of sanitary and phytosanitary measures.

All of these things seem to put us at a substantial disadvantage until we have progress in those areas on this particular sector for export base. I do not know if you have any reaction to that, but I think those are significant problems that need to be addressed.

Mr. FREEMAN. Congressman Bereuter, thanks very much. As Mr. Martin and others know, agriculture has been one of our abiding concerns and abiding focuses of the Administration since December 2001. All of those issues that you raised are right at the top of our agenda.

On biotech issues, we are waiting for the permanent safety certificates to be issued. They have extended the interim regulations until April 2004. But, again, we are waiting for the final shoe to drop there.

The labeling requirements, again, are a continued problem that we have been pushing. It is not simply a problem of labeling. It is that the labeling is so inconsistent, so it is hard to actually put your thumb on it. SPS regulations are a continued bane. We just had four soybean shippers that were threatened with a ban on their exports for alleged SPS issues that, in our view, just "ain't so."

So, apparently we have gone into technical talks with them on that issue. What they have said is, as long as those technical talks are proceeding, they will not implement the ban.

But, again, what all these actions do, is they do create a cloud over the marketplace and they do make trade that much more difficult. That probably adds some extra cost to our exports, and that is something we really want to avoid.

Representative BEREUTER. It does, indeed.

A week ago today, I had a chance to express my concerns to Secretary Evans at a party caucus of the House. My concern related to the fact that the European Union, it seems to me, is outstripping the United States in dramatic ways with respect to their work with the Chinese authorities.

They are in China and they are assisting, for their own benefit, the Chinese to write the standards for manufactured products. Those standards oftentimes are not—in fact, usually are not—the same as we have in this country.

Therefore, the long-term impact of their success in working with the Chinese is going to dramatically hurt our manufacturing base. I think my advice to him is, we cannot protect our interest in the Chinese markets on the cheap.

The USTR is a very lean agency; I hope lean and mean in a positive sense. But the Commerce Department, the USDA, and the State Department have to be in greater numbers on the scene in Beijing and in China, and we do not have enough people to do the job in that location.

The impact is going to be very detrimental in the short term and increasingly detrimental. I want to give that message to you once more, to the Administration, that you cannot do this on the cheap. You have to be there with people that are well-trained, and now is the critical time. We do not have any time to lose.

Would you like to respond?

Mr. LEVINE. Yes, I would. Thank you.

With regard to the specific issue of standards, I absolutely could not agree more. I know Secretary Evans, of course, has attached a tremendous amount of importance on the issue of standards. It really is a strategic choke point, in a sense.

If we get the standards issues wrong, as you suggest, if in fact the EU or others promulgate standards which effectively shut our products out of the market, the results, indeed, would be tremendously damaging.

For that reason, let me just say we have been undertaking a very active program at Commerce, and in fact are continuing to build on that program. Just this week, the Chinese standards organization was in town and signed an MOU with the National Institute of Standards and Technology [NIST] for further cooperation.

We have coming up several planned seminars and workshops. We are talking with the U.S. private standards development organizations about finding a way to increase or to have some representation for them actually on the ground in China.

We are, in a word, trying to make very strong efforts in this area, and will continue to do so. I agree completely, this really is a critical issue for us.

Representative BEREUTER. Well, as a representative concerned about the export base in my own district and State, and our national concerns, I could not help but raise these issues, these commercial export issues, with you.

Coming to the mandate of this Commission, in the area of corporate social responsibility, we have three particular findings. I will just mention two of them very briefly for you and the people gathered here.

The first, contract factories that are not owned by U.S. companies produce many of the products that China exports to the United States. Many factories that sell nearly all of their products to U.S. consumers receive only indirect consumer pressure to provide adequate working conditions for their employees, directly to human rights kinds of issues.

Second, despite the good efforts of some U.S. companies sourcing from China, current efforts by these companies have not significantly improved working conditions in Chinese contract factories. These companies are beginning to recognize that auditing is not enough to assure acceptable working conditions.

Now, we have to have an impact on what happens in China through our American commercial enterprises and the contract fac-

tories that so most of the work in producing those products that they in turn export to us.

I would hope that we are having the same kind of interest on the part of the European Union and Japan, for example, that they have that kind of social responsibility, but I am not confident that they do.

I have been told, Mr. Freeman, from what seems to be a reliable source, that one-third of the exports from China to the United States today are to Wal-Mart. Do you think that is within the realm of possibility? By value.

Mr. FREEMAN. I have heard similar statistics. I have heard that Wal-Mart does import a tremendous amount from China. I know that Wal-Mart is also very focused on market access in China, and they are one of the fastest growing retail operations there. So, there is some two- way trade there, but they do a tremendous amount of business there. That is true.

Representative BEREUTER. Well, it must be a very large amount. It is a third, perhaps, or maybe more. Somewhere around that, I would guess. They are a behemoth in this country in the retail sector and are rolling over their competition. They are the largest grocer in the country now. You can buy everything at Wal-Mart, as you know.

It seems to me, Mr. Chairman, that if we had an opportunity for Wal-Mart to come and talk to us, we could, by influencing the policy of one company, dramatically impact the contract factors in China and the working conditions in which the Chinese work, and also the competitive situation that our own producers face in this country.

I would like to suggest that maybe the place we focus some attention on social responsibility is on the giant. If we can get good cooperation and movement on their part, it not only sets a good model for the rest of the Americans and hopefully for the Europeans and Japanese. At least we could get some early results if we can convince them that this is an important priority they should have, and that the dollar is not everything.

I welcome any final comments you might have on the question, but those are the things I wanted to put on the record at this point, Mr. Chairman.

Chairman LEACH. Do either of you want to comment further on Mr. Bereuter's incredibly thoughtful observations?

Mr. LEVINE. I would just add that, on the corporate social responsibility side, Secretary Evans, as I think you may know, has attached enormous importance, and I think in the context of his upcoming visit to China we are looking at events, in fact, that can highlight his commitment and the U.S. commitment in this area. So, that is also something that I know he feels very strongly about, and we are working as best we can in that area. Thank you.

Chairman LEACH. Ms. Kaptur.

Senator LEVIN. Mr. Chairman? Just very quickly.

Chairman LEACH. Yes, Senator. Would that be all right?

Representative KAPTUR. I would be pleased to yield to my champion, the Senator from Michigan.

Chairman LEACH. Why do we not do it this way, then. Since no Senator has been recognized yet, why do we not recognize you, Senator.

Senator LEVIN. I do not want to go out of order. I just ask you to yield for 1 minute.

Representative KAPTUR. I would be pleased to yield.

Chairman LEACH. Please. Yes, of course.

Senator LEVIN. On the report, I am in support.

Chairman LEACH. Thank you.

Senator LEVIN. I want to thank the Commission and want to express my strong support for including the question of currency manipulation by China in our deliberations and to find ways to do that in assisting with our mandate. There are ways to do it, I believe, in reference to the WTO.

My brother made reference to Chinese currency manipulation in his opening statement, and the impact it has on our exports, and that it is a subsidy to Chinese exports. This is an important issue that needs to be included as this Commission proceeds next year. I want to thank the Chair, and thank you, Congresswoman Kaptur, for allowing me to intervene.

Representative KAPTUR. I would yield for you any time.

Chairman LEACH. I would ask the gentleman to yield briefly from his intervention and simply stress that I think this is a seminal issue in our trade relations. I also think that there is a point that has to be stressed from the perspective of the U.S. Congress.

Many in China are saying, what are we doing suggesting a precise, new peg for their RMB? I would stress, we are not. What we are suggesting is that there ought to be a free trade in currency and that the market would determine the value. That is different than saying their RMB ought to be revalued 2 percent, 8 percent, 40 percent. It simply is, let the market determine the value.

I would also stress that, from a manufacturing perspective, there are clear and obvious implications. But from a total wealth perspective, a strong currency from China's view has some real pluses for their society in terms of their capacity to buy foreign goods and to buy more of their own goods.

This is not an effort of an American society that thinks it is being totally disadvantaged to achieve something process-specific, it is simply to press a principle, and the principle is free trade and fair trade. That is very different than saying a precise, pegged point.

Senator LEVIN. I thank the Chairman for that. It is clear that what China is doing is manipulating the currency to advantage their exports and disadvantage our exports, and that is not allowed by the GATT.

The GATT does not permit, under article 15, WTO members from taking action to frustrate the GATT provisions. That is what China is doing in pegging its currency the way it does, and it is having a severe effect.

Both management and labor, companies and unions, are together in this country, to try to stop China from taking these actions and doing that manipulation which so disadvantages our exports and advantages their exports. It costs us jobs, especially in the manu-

facturing area, where now over 2.5 million manufacturing jobs have been lost in the last couple of years.

So, it is important that we include the issue of Chinese currency manipulation in the next report, and find ways to include this issue as we discuss the WTO.

Chairman LEACH. Fair enough. At the risk of presumption, I want to make a concluding point to emphasize the concern of people in other societies and publics. When governments intervene to skew their currency, private markets are much larger. When inevitable changes occur, it is public treasuries that lose sums of money.

So, if you take the Japanese intervention which your brother raised, if there is a movement of the Japanese currency, let us say, of a 20 percent direction and the Japanese government has intervened to the tune of, let us say, $300 billion, the public in Japan loses 20 percent times $300 billion, which is a $60 billion loss to the public of Japan.

Japan is moving in this direction, partly because other countries have skewed their currency relationships. But it causes huge losses of public funds when you have these pegged currencies that governments intervene to try to prop up. That will inevitably be the case in China.

Senator LEVIN. I admire the Chairman's optimism in attempting to persuade the public in China and Japan that it is not in their interest to do what they are doing. I admire you no end for that effort. I had given up on that a long time ago.

I think it is particularly important that we let them know that we are not going to tolerate it. It is not in our interests that they be allowed to do what they have been doing in China and Japan for such a long time. I would add what I think is our principal need, but I must say, again, the Chairman is absolutely right, that it is not in their interest, ultimately, either.

But I am not so sure that they are going to see it that way. In the meantime, I think we have got to make it clear to them what is clearly not in our interest, that they continue to do the manipulation that China, Japan, and others have done for too long without contest on our part.

Chairman LEACH. As usual, the Senator from Michigan is more profound than I am.

Ms. Kaptur.

Representative KAPTUR. Thank you, Mr. Chairman. Just to follow up with an observation. The anemic U.S. growth rate has been reduced by a third because of our ongoing and growing trade deficits with the world, China now being our leading trading—what would we call it—deficit partner, Japan being No. 2.

I remember, as a young, naive Congresswoman coming in here 21 years ago and being told, "Oh, Congresswoman, it is only a currency problem. At that point, Japan was the leading trading partner with the United States. The problem is not that they manage their trade, Congresswoman. The problem is the yen. When we get the right yen/dollar relationship, we will have a balance." Wrong. It will not happen because it is not a free market with Japan. It is a managed market with Japan. It does not matter if it is 150 yen to the dollar or 98. We continue to sustain $50 billion trade

deficits with that country every year, largely in the automotive sector. That is No. 1.

And, believe me, we have written bills, we have tried to get market opening. In 1983, less than 3 percent of Japan's market were automobiles or parts from anywhere else in the world. In 2003, the same number.

So you can fiddle around in a side show all you want, but in the end the trade deficit is your measure and it has been failure, after failure, after failure of this country actually moving those balances in our favor.

Now we face China and, again, a managed trade situation. Under your gentlemen's watch, our trade deficit with China has doubled. It has doubled. Now, you would not get a passing grade of A in any school if those numbers kept going up from the standpoint of the people of the United States.

Now, you can spend all the time in the world concentrating on the currency exchange. But let me tell you, when you have managed markets, it will not matter because Japan is our model of what has happened, and we have continued to erode production.

I guess there is an assumption by some that America will just cash out everything: since the year 2003, now, 3 million more manufacturing jobs; in the agricultural sector, 50 cents of every U.S. farm dollar, now Federal subsidy, only to hold the farm credit system together or we would have a collapse like the 1930s.

Something is fundamentally wrong with the trade accounts. It is at the highest of policy levels. I was looking at how long you gentlemen have served in your current positions, and we are very happy that you are there.

But you are not going to succeed because the fundamental policy is wrong. The United States is essentially cashing out her wealth. The reciprocal of that trade deficit over 20 years is the amount of our public weal.

The Chairman has talked about the public side, that it is now owned by foreign interests, nearly half, with China being our largest creditor and Japan No. 2.

We are paying them interest now. Why would they want to reduce their currency exchange with us when they are getting pretty good interest rates at the moment? So, we are living on borrowed capital. That is all we are doing right now in this country.

I would like to ask you gentlemen a question. In the last year, how many times have each of you traveled to China to deal with these issues that we are talking about here this morning? I am just curious.

Mr. FREEMAN. I have been, in the last year, probably five times.

Representative KAPTUR. Good.

Mr. LEVINE. I just assumed my current portfolio handling China and other parts of Asia only 4 months ago, I guess. I have made two trips to China in that time, and will be going out again next month with Secretary Evans.

Representative KAPTUR. I know those are very wearying trips.

I would like to propose this. I do not know if we do it through this group or I do it separately, but here is an example.

Huffy Bicycle had 2,000 people employed in Ohio manufacturing the best bicycles America had. Two thousand workers who have all

now lost their jobs. They earned a living wage. Was it the highest wage in the world? No. They had health benefits. They produced a fine product.

That Huffy Bicycle is now being manufactured in China. I would like to visit that facility in China with you gentlemen, and I would like to take some of the people that used to work at that plant in Ohio with us.

I would like to compare the working conditions of the people who now manufacture those bicycles and I would like to compare the quality of those bicycles compared to what the people in Ohio used to make.

Those bicycles come back to places like Wal-Mart and K-Mart. And you know what? The price did not go down. The workers in China make about 10 cents an hour. I think it is important for American to understand the differential on which certain global interests are trading.

They are trading on the exploitation of workers who work for starvation wages. They are trading on environmental conditions where we are leaving cesspools around the earth. There are certain wealthy players in the international realm who take great advantage of this situation.

Until we fly in the face of that, we are never going to balance these trade accounts. Meanwhile, jobs across this country and the wealth of this country, more than money, but the manufacturing and the agricultural wealth, continues to get cashed out.

I really want to go with you. But I do not want to go to some abstraction about some currency exchange that is going to be changed because we have some kind of belief that the world really operates in free markets.

It does not. We have managed trade. When you have countries that follow a managed trade regimen, you get trade deficits. We end up being the dump market of the world, and shame on us.

We also do not make lasting friends around the earth. So, to me these trade deficits are unsustainable. I really want to go with you, but I want to take the people from my area. Let us look at this right in the eye. This Commission is a way to do that. Congressman Levin asked for something more tangible. Let us make it more tangible.

I wanted to ask a question. That is, do you believe that the trade deficits that we are now experiencing with China are sustainable for the health of this economy inside the boundaries of the United States?

Mr. FREEMAN. Well, Congresswoman, thank you for that. On the question of going to China, I think that would be very useful, for a couple of reasons.

Representative KAPTUR. Great.

Mr. FREEMAN. First of all, I think not only would it be useful for your trip and the trip with former workers at Huffy to see the conditions there, it also would be very useful for the workers in China to exchange views and know what they are missing out on, perhaps. So, I think it would be a very useful trip and I would be happy to recommend to Ambassador Zoellick that that trip take place.

Representative KAPTUR. Thank you.

Mr. FREEMAN. With respect to the trade deficit question, I am not an economist. I am just a humble market access person. I will say that, in terms of the deficit with China, it is the largest growing percentage of our overall deficit. It is about 22 percent of our overall $463 billion deficit.

But it is slightly confusing, because one of the problems is that a lot of the things that we used to buy from places like Indonesia, Malaysia, and Thailand have shifted to China. So, actually, China's deficit has increased, while the deficits from those other places have come down.

The other problem is that our deficit has increased recently because our exports have come way down. About half the new growth in deficits has resulted from our exports having decreased. Interestingly, that is not the case with China. While our exports to the rest of the world have decreased about 8 percent, in the last few years exports to China have increased about 65 percent. China is our fastest growing market.

So, the growth in the deficit with China is certainly something that we are particularly focused on and concerned about, but there are other issues that are at play. One is that China is taking up a new share all on its own of the overall deficit. So, again, it is a complicated issue. But I think the fundamental thing that we would like to get to, is to make sure that the playing field is fair.

Chairman LEACH. If I could interrupt, briefly. We have a vote on the House floor. We have about 10 minutes left on the vote on the defense appropriations conference report. I think we are obligated to recess, with the exception of the Senate members. Senator, would you like to continue?

Senator DORGAN. Mr. Chairman, I would.

Chairman LEACH. Would that be all right with you, Marcy? Then we will return to you when we come back.

Senator DORGAN. Mr. Chairman, if you do not mind, let me inquire. We have Secretary Rumsfeld downstairs in the Appropriations Committee.

Chairman LEACH. Sure.

Senator DORGAN. Let me inquire for a few minutes, and then I will put it in recess.

Chairman LEACH. I think that would be very appropriate.

Senator DORGAN. Thank you very much.

Chairman LEACH. Then we will put you in full charge, and then recess and we will return. Thank you.

Senator DORGAN. I had forgotten how much I admire the passion of Congresswoman Kaptur, I must say, before she leaves. The passion on this issue is very important.

I regret that you will miss my questions, Mr. Chairman, and the answers from Mr. Freeman and Mr. Levine. But I will try to make notes.

First of all, let me thank both of you for your service. I appreciate people coming to public service and offering themselves for public service. I know that you work in an area that is very important to this country.

I share some of the same concerns that Congresswoman Kaptur does. I think our trade policy is a colossal mess, getting worse, not better. Much, much worse. I see things happening in international

trade that make no sense at all. I will describe just a couple of them. I do want to ask you a couple of questions.

The China situation is very interesting to me because I was on the House Ways and Means Committee many years ago. I believe our deficit with China then was about $10 billion a year. I told my colleagues who were pushing a policy, this is going to explode on us. Indeed, it has. There was a $103 billion deficit last year with China.

I come at this from the standpoint of, particularly, agriculture, but I am very concerned about manufacturing jobs and the export of jobs from our country.

Let me ask a couple of questions. Mr. Freeman, you would expect I will ask questions about wheat. We produce a great deal of wheat. It was not too long ago, a couple of decades ago, we were selling $500 million worth of wheat in a year to China. Now it is 1/20th of that, $25 million.

What I want to ask you about specifically is, my frustration is, we never taken action. We do not have a backbone. We do not have the nerve, the will, to stand up and say, this is wrong and we are going to fight for the right result. We just do not do it. We are sort of squishy on all these issues.

There was a fellow named Bruce Quinn who left USTR. He was an associate of yours who, on March 17th of this year, was speaking at a wheat industry meeting. There was a reporter there, and the reporter reported what he said.

In an explosive fit of candor, Mr. Quinn said that the Trade Policy Review Group in this Administration, which includes all the major Federal agencies involved in these issues, had given the USTR the "green light" to proceed with a case against China for blocking sales of U.S. wheat to China.

So, someone from USTR, 1 week before he left USTR—now, that is an important point. He was actually leaving, going to go out the door, and in a fit of candor told the wheat industry meeting that the Trade Policy Review Group had given a "green light" to USTR to file a trade action against China for blocking the sales of U.S. wheat. What he said was that USTR was deciding not to do that because it was thought this would be an "in-your-face" thing to do to China.

I wrote to every one of the Federal agencies that belonged to the Trade Policy Review Group and asked them, "Is this the case? Did you, in fact, as a Trade Policy Review Group, give the green light to USTR to take action against China with respect to blocking wheat sales?"

They all wrote back. No one denied giving the green light. Some outright, in fact, said they had done so. If I showed you the letters, it is kind of a mishmash of wonderful comments.

But it appears to me that someone had decided at some point in the Trade Policy Review Group to take action here, and the Trade Policy Review Group had actually said, here is the green light, take action against China for blocking wheat sales. No action was taken.

Can you give me some background on that? Was there, in fact, that discussion? Was there a decision that the green light was given to USTR to take action? If so, why was action not taken against China for blocking U.S. wheat sales to China?

Mr. FREEMAN. Senator, thanks very much. If my buddy Bruce were here to respond, I am sure he would. Bruce Quinn left our office. He is actually a Commerce employee. He is now stationed in Chennai—formerly Madras. He's the senior commercial officer there.

What he said, basically—well, I will not paraphrase what he said, but let me tell you what essentially happened. TRQs. Tariff rate quotas. China, for some time now, has not implemented the system of tariff rate quotas to the extent that we think they ought to have. Tariff rate quotas cover a variety of things, cotton, corn, soybean oil, and wheat.

One of the issues was that we have had four problems with tariff rate quotas with China, four problems with China's administration of tariff rate quotas. First of all, they have a catch-22 licensing situation. You need to have a contract in order to get a tariff rate quota allocation, but you cannot get a tariff rate quota allocation unless you have a contract. There is a real lack of transparency.

When they do allocate a TRQ, we do not know who is getting it, so it is very difficult for our traders to find out who has got the right to buy wheat, corn, or whatever it might be.

There also was a subquota for processing trade, which, in other words, meant that part of the tariff rate quota that was set aside had to be processed, which, in our view, did not conform with WTO standards.

Finally, they were allocating tariff rate quotas in very small numbers, 2 or 3 metric tons, which, if you know, trying to ship 2 or 3 metric tons to China does not make commercial sense. The cost does not make sense.

So what we did is that Al Johnson, who is our chief agricultural negotiator, Ambassador Zoellick, and others got together with Secretary Veneman and said, "We have been pushing this issue for a while. We are ready to go. We want to push forward on this, and we are looking at a WTO option here."

But, as you know, like any legal process, WTO action is not a magic bullet. It takes time to resolve. While you are going through the process, how much wheat are you selling? How much cotton are you selling? How much corn are you selling?

So the question is, "Can we work out with China bilaterally a resolution to these issues or are we forced to go directly to the WTO? Are we going to say, the heck with it, let us go forward?"

The issue was that the Trade Policy Review Group got together and said, "Look, Ambassador Johnson, if you cannot work it out with the Chinese, go for it." Ambassador Johnson went to China. I went with him. We worked it out.

We have got two of our key issues resolved. We have got a third they said they have resolved, and a fourth they say that you will see that it is resolved by January when we allocate quota for 2004. So, right now, again, out of the process of doing that, we have sold a heck of a lot of cotton this year.

Now, wheat, as you probably know, has been relatively high priced in this country for the last year or so because of conditions, and in China the price has been relatively low.

Senator DORGAN. Well, you do not own a farm then if you think wheat is high-priced.

Mr. FREEMAN. No, I know. I understand. But the issue is that the market price in China has been relatively low. This year, it is going to be high. So, now we can see whether they are actually going to implement on wheat, and that is going to be the key thing for us in January.

Senator DORGAN. But the Chinese Government, I understand, has decided that only 10 percent of the licenses are available to private importers, 90 percent reserved for the Chinese Government, about. Therefore, the Chinese Government decides whether they will or will not buy American wheat. Is that not correct?

Mr. FREEMAN. There is a certain percentage that has been reserved for State traders.

Senator DORGAN. Is it 90 percent?

Mr. FREEMAN. I do not know what the exact number is. I certainly can get it for you.

Senator DORGAN. Well, I am told it is 90 percent.

Mr. FREEMAN. I can get it for you.

Senator DORGAN. That is more than a certain percent.

Mr. FREEMAN. I can figure it out.

Senator DORGAN. Well, let me ask this. We did the bilateral with China, and as you know we did not vote on that. Had we been able to vote on it, I certainly would have voted "no," for many reasons.

I will give you automobile trade, just for one. Our negotiators, whoever they were, sat down and said to the Chinese, after a long phase-in we will agree to have a tariff on U.S. cars going to China that is 10 times higher than we would have as a tariff on Chinese cars into the U.S. market.

I do not have the foggiest idea, when you have a $100 billion trade deficit with a country, how you sit down and decide that, on auto trade, they should have a tariff that is 10 times higher and sanction that in a bilateral.

I think it is incompetent. I do not know who negotiated that, but I think it is fundamentally incompetent. Aside from that, when we did the bilateral, with respect to wheat, there was established an 8.5 million metric ton TRQ level.

There was this euphoria by some. Not me. What a wonderful opportunity to ship wheat to China. Then the agriculture minister of China went to Guangzhou, and then the South China Morning Post had this to say. The minister said, "You know that 8.5 million metric tons? That is just theory. It does not mean that is what is going to happen here."

It seems to me that if you follow the trail of evidence, that you come to an inescapable conclusion that even Inspector Clouseau could reach here, that the trade with China is fundamentally unfair and ought to require us to take action.

I understand your point, Mr. Freeman. You say, "Well, we could take action, but of what value would that be if we are still negotiating?" My question is why are we negotiating in the immediate shadow of having reached an agreement? One would expect, with a country like China in which we are a cash cow for China's hard currency needs with this huge imbalance of trade, one would expect that, when we reach a bilateral, you would not have to, 6 months, 12 months, or 18 months later worry about whether there is compliance. You would, by God, expect there is compliance.

So, on behalf of wheat farmers, I would just say to you, if somebody has been given the green light to go take action against China on behalf of our wheat farmers, I want you to stand up and take action on behalf of our wheat farmers and say to China, you have an obligation to let wheat into China. You have an obligation to buy our wheat.

So you say, well, our wheat is expensive. I will tell you, the price of wheat is not anywhere close to being expensive if you are raising it and selling it. It does not meet the cost of production.

I do not want to hear the Chinese tell us that we have expensive wheat. That is nonsense. We have a lot of wheat they ought to be buying, and they are not buying it because they explicitly, in my judgment, want to keep it out of the Chinese marketplace.

And if they want to ship us all their trinkets and their trousers and their tennis shoes and their shirts, good for them. But our market ought to be a sponge for other goods from other countries only if their market is open to us, and only if trade is fair.

Frankly, our farmers understand that trade with China is not fair because they are keeping our wheat out. I really want you to file an action, take action. You are saying to me, I think, today, Mr. Freeman, that we will see the final result of these negotiations by January.

But I will tell you something, both on the Ways and Means Committee in the House and also in the Commerce Committee here in the Senate, for, I guess, now, 20 years, I have been hearing people promise that it will be next January, or next month, or next week, or just over the next hill, or just around the next curve, that somebody is going to see some of the good happen on behalf of American producers. But nothing good has happened with respect to China.

I will make one other point. I do not mean for this to be painful for you to listen to. You indicated that China is our fastest growing market, but that is a statistic that is almost irrelevant. That is like me saying, on average, Bill Gates and I are worth $32 billion between the two of us. So what? Is it true? Sure, probably. But I have nothing.

The fastest growing market? Take a look at the imbalance and take a look at the sector-by-sector analysis, and then understand the passion of my colleague, Congresswoman Kaptur, whose Huffy bicycles are not produced in this country, they are produced elsewhere. Why? Because of free trade? Absolutely not. Because of other sets of circumstances that create what we think is a fundamental unfairness in our marketplace.

So, let me come back and say that I want both of you to succeed. This is not a criticism of this Administration. You could put a blindfold on and listen to the murmurs of Trade Representative officials from Democrat and Republican administrations for 20 years and you could not tell which administration was speaking, with one single exception, and that was a momentary lapse during Mickey Kantor's term when we slapped TRQs on Canada and had a significant impact on some grain issues with Canada. Otherwise, it all sounds the same. Meanwhile, the problem gets worse and worse and worse.

So, having said all that, which is extraordinarily therapeutic for me this early in the day, I want to ask you to be willing to take action. We have trade dispute resolutions for a very specific reason.

That is, when somebody is not complying, then we have a right. We have a right to go after them and say, "Our market is open to you, but your market must be open to us, and it is not. Sell your trinkets in Zambia."

Well, you might want to respond to some of that. But are you willing to take some action next week? [Laughter.]

Mr. FREEMAN. I am going to demur on that. I will say that I do not think that there is any reticence about taking action in the Administration. The idea, though, of course, is to make progress. While I can tell you, having gone through my own share of frustrations, that it would be somewhat therapeutic for me to take it next week, too.

But I will say that your passion and leadership on this is well known, not only within the Administration, but in China. Your voice is something that China needs to hear, too.

I have had conversations with your staff at some point about the usefulness of your taking a group of wheat farmers from your state or elsewhere and making sure that the Chinese understand how important it is, not just for the Administration, but to wheat farmers and to the Senator from North Dakota to actually buy North Dakota wheat. I think that is a message that they need to hear.

Senator DORGAN. Yes. Well, I will take farmers to China if we go on a boat filled with wheat. [Laughter.]

And you promise, that they will buy it when we get there. I will take farmers to China, but only to sell wheat.

Mr. FREEMAN. I will see what I can do. [Laughter.]

Senator DORGAN. I took a farmer to the Canadian border 1 day in a 12-year-old orange truck, and we could not get 200 bushels of durham into Canada. All the way to the border, we were met by 18-wheelers hauling Canadian grain south. So, we are a little sore about some of these one-way trade agreements,

And I will certainly take you up on your offer, but we want that offer to include wheat moving to China in significant quantities.

Well, Mr. Freeman, I want both you and Mr. Levine to succeed.

One other question. Market access compliance. That is you, Mr. Levine? Both of you?

Mr. LEVINE. We share the responsibility, I would say. It is in the title of my position, actually.

Senator DORGAN. You are with USTR and you are with Commerce. We have Commerce/State/Justice appropriations coming to the floor, and I am fiendishly working on how I might improve that for you all.

Can you tell me how many in Commerce, working on market access compliance, are tasked with the issue of dealing with China, specifically China? How many people are involved in dealing with the China trade issue?

Mr. LEVINE. Yes, Senator. In fact, it is a number that has grown substantially over the last, I guess it is, 5 or so years. Our China office in the market access and compliance part of Commerce has grown from 7 staff to a total of 18 today.

In addition, of course, within China itself we have something in excess of 90 Commerce Department staff. That includes the Commercial Service, with a strong trade promotion focus.

Included in that number we have two market access officers based at our Embassy in Beijing. These are both American lawyers hired out of the private sector. They have extensive experience representing U.S. companies in China. They both speak Chinese. They are working full-time at our Embassy in support of market access.

Senator DORGAN. You talked about promoting trade. My interest is in requiring compliance. So are you mixing the two with respect to these 18 people?

Mr. LEVINE. No. The 18 people are market access and compliance, yes, then the two at our Embassy in Beijing as well, supported by Chinese employees.

Senator DORGAN. How many of those 18 are stationed here in Washington?

Mr. LEVINE. All of the 18 are here in Washington, plus we have two focused 100 percent on market access and compliance at our Embassy in Beijing.

Senator DORGAN. In fact, my colleague has returned from the House. Let me just finish. I know others will return in a moment. But I am going to be dealing with this issue on the floor during the Commerce/State/Justice appropriations process. We have grown from 7 to 18.

In fact, if you take a look at China, Japan, Europe, Canada, Mexico, Korea, which are major areas of, I think, significant trade challenges, I think we dramatically underfund the resources that are necessary to really deal with market access compliance and enforcement of trade laws.

Now, it does not pay to have much of our resources devoted to enforcement if nobody is willing to enforce anything, if we are just going to all sit around and play cards and sip warm tea and talk soothing things about how wonderful we all are.

It does not mean anything to me. What means something to me is if we are going to ask other countries to live up to their obligations in international trade. We never have. There has been no evidence that that has ever been a priority.

Well, I have had some really interesting opportunities to spend some time. You went all the way to the U.S. House and back again? Time flies when you are enjoying it.

Let me thank both of you for being here. I will pursue this further.

Chairman LEACH. Senator, I will tell you, one of the longest distances in America is between the U.S. Senate and the U.S. House. [Laughter.]

Senator DORGAN. Especially now.

Chairman LEACH. We have managed to return, and we are very appreciative of your hospitality on these shores. If you want more time, you are welcome to have it.

Senator DORGAN. I thought you were talking about the construction, but you were actually talking about elections.

Chairman LEACH. No, I am talking about the ethereal psychological distances that have to be traversed. [Laughter.]

Senator DORGAN. We are like one. [Laughter.]

Chairman LEACH. But we are observers, and as observers, we want you to know we are very impressed with your career, sir. Thank you.

Ms. Kaptur, you were in the middle of your questions.

Representative KAPTUR. Yes, Mr. Chairman. I am sorry I missed Senator Dorgan's questioning. I know I would have been enlightened by it.

I wanted to continue with a line of questioning on how much trade deficit for the United States is sustainable, with China or with any country, indeed. As you look toward the next year, what are your goals to reduce the deficit?

Do you have a target, an Administration target to move this trade deficit down? Do you have specific targets? I would be very interested in that.

Then I wanted to ask either of you gentlemen, do you view China as a democratic country? Then, finally, what is the average wage in the manufacturing and in the agricultural sector in China?

Mr. LEVINE. I will follow up and respond further, Representative Kaptur. Let me say, first, I am not aware of an Administration target in terms of the deficit. Again, certainly our focus remains on making sure that China complies with its commitments, that we remove market access barriers so we can increase our exports and, further, take the steps necessary to enforce our trade laws and deal with unfairly traded imports from China.

So, in terms of the policy thrust we are very much focused on that, but I am not aware of any particular target on the deficit.

If I could actually back up for one moment to your earlier comments and say, first of all, that I would be delighted also to help facilitate and go along on your visit.

I will say that, in a previous incarnation as the U.S. Consul General in Shanghai, I had the pleasure of arranging a visit—this goes back a couple of years now—by Senators Lautenberg and Harkin to a contract apparel factory located outside of Shanghai. Again, I think that was worthwhile, and I would be delighted again to work on this effort as well.

Representative KAPTUR. Thank you. I really appreciate that. I am sure some of my colleagues would have similar interests.

Mr. LEVINE. With regard to the question, no, China is not a democratic country by any means. It is not a democracy. With regard to the average wage numbers, I think I would have to get back to you with the specifics on that.

Representative KAPTUR. Do you have a feel for it? Is it over a dollar an hour?

Mr. LEVINE. I have heard sort of varying numbers in different parts of the country and so forth. Certainly, it is a fraction of comparable wages here in the United States in any comparable job. I would feel better about getting back to you with really some more solid data.

Representative KAPTUR. I really thank you for that. I notice that, in terms of U.S. exports to China, certain machinery and electrical goods are gaining in ascendancy. I would like to posit the theory, as we look at what has happened in other places, those are the machines to manufacture the goods that will then displace more jobs

here in the United States. It is an intermediary step that occurs in the displacement process.

Yes, Mr. Freeman? Did you want to comment on the sustainability of this level of trade deficit, whether you are aware of whether USTR has a goal for this year to reduce the trade deficit with China?

Mr. FREEMAN. We do not have a numeric target, at least that I am aware of. Again, I think I will leave it to the economists to decide what is sustainable and what is not. I am just not qualified to comment.

Again, our focus is market access, making sure that we increase both the openness of China's market and that China plays by the rules in international trade, and hope that, through the combination of that, that that will take care of issues like deficits, and so forth.

I do not know what the average wage is. As Mr. Levine was suggesting, there are different parts of China that have radically different standards of living. The coast is increasingly a wealthier part of the country and, therefore, has a higher standard of living. The internal part of China is extraordinarily poor, where I think a dollar a day is probably significantly more than the average wage.

Representative KAPTUR. Would you guess that a third or more of the exports to the United States come from the Guangdong Province area?

Mr. FREEMAN. It is up there, yes. Shanghai is probably close.

Mr. LEVINE. I think it is possible, from that area. Again, I think we would be probably better served, and you would be better served, if we really take a hard look and get you solid data.

My recollection was that, at one time, almost 40 percent of China's exports were coming out of the southern part of China, including Guangdong Province. But, as I say, we would be happy to update those statistics and get back to you with some solid numbers.

Representative KAPTUR. I thank you very much for that.

Mr. Freeman, do you believe China is a democratic country?

Mr. FREEMAN. No, China is the farthest thing from a democratic country. I am sure it will be some time before they do become democratic.

Representative KAPTUR. Mr. Chairman, if you would just let me close with this comment. As we watch the fall of the Soviet Union and the transformation of internal economies in Russia, Ukraine, Belarus, et cetera, it has been very interesting to watch the politics and the economics proceed.

I think one of my concerns with a country that is undemocratic is, as Wal-Mart, as Mr. Bereuter referenced, conducts business in China, whom are we empowering economically and what connection does that have to the politics?

When you put aside politics as an important ingredient in relationships and you concentrate only on economics, what kind of a world are you really producing? So, I do have some questions in my own mind as to who, politically and economically, we are empowering inside China, an undemocratic country.

As people purchase goods in the United States and those dollars flow back to Chinese interests, whom are we empowering and what

kind of system will we bequeath to our children and grandchildren? It is a question I would let hang out there, but a deep concern.

We thank you very much for your appearance today.

Mr. Chairman, thank you so much for allowing me to complete my questioning.

Chairman LEACH. Well, thank you very much, Ms. Kaptur.

Mr. Wolf, do you have any questions?

Representative WOLF. I want to follow up. We cannot sustain it. The National Association of Manufacturers [NAM] has predicted that the trade deficit with China will be roughly, I think—well, I do not want to say a figure that is not accurate. They have been by to see me.

I think they said it would be roughly $600 billion, and the deficit with trade with China in 2005 or 2006—I will submit it for the record—would be something like $430 billion. We cannot sustain that. I mean, no country has ever, every sustained that.

Two, I was glad to see you say that it is not a democracy. It is not.

[The information follows:]

The National Association of Manufacturers has predicted that next year—2004—the deficit will be $125 billion and will increase to $330 billion in 5 years.

Representative WOLF. I wanted to ask you a couple of questions. Following up on what Ms. Kaptur said, would you give us within the next week, because this thing has been on my mind—and I listened to an interview with a woman in China. Her salary was $17 a month. She worked six days a week, 12 hours a day. One lady who was the supervisor, or the boss, if you will, was making $27 a month.

So, could you give us, both of you, maybe, a side-by-side, hourly wages, wage-an-hour, overtime, EPA. Just take everything that our people have to go with, EPA, family leave, the number of vacations, and then compare it with what China has. Because there have been a lot of stories, and I think Ms. Kaptur is right. When I heard her interviewed, I thought the salary was higher, but she felt that she was doing very well at $17 a month.

She talked about the conditions, and this being much better than she would have ever expected. Yet, at $17 a month, that is probably about an hour and a half for a Wrangler jeans manufacturer somewhere down in southern Virginia. I think they made $10.50, $11 an hour.

So, if we could get that side-by-side, perhaps by the end of the week on all of the issues, health care, anything and everything an American manufacturer has to do in comparison.

The only other question that I have is, and I want to thank the Administration for it. It looks like you are finally catching the vision about how serious this is. For a long period of time, I think the Administration was not focusing.

But with the job loss, and I think Secretary Evans' speech in Detroit the other day, and the comments and relationships that we have had with the Department, both of your departments over the last couple of days, I do want to thank you for the fact that I think you now understand this problem and are aggressively being involved in it and trying to reverse it.

If China were to comply in an honest, ethical, moral, decent way by the objective man test to the WTO, what percentage of the problem would go away?

Mr. FREEMAN. I do not even want to hazard a guess there. I think what you would see, is you would start to see a reversal of fortune here. Not a complete reversal of fortune, but I think you would see the growth at least slowed in the deficit and probably reversed.

Representative WOLF. Has anyone, from a scholarly basis, done a piece objectively saying where China was not in compliance? I mean, we know there are so many cases. It just goes on and on and on.

Mr. FREEMAN. I do not think there has been one comprehensive academic study of non-compliance. There have been some in the area of agriculture. To be quite frank, I think the report that we do to Congress every year is probably about as comprehensive a survey of China's compliance as we would get.

Representative WOLF. In the State/Commerce/Justice bill, we are setting up what we call Team B. Ronald Reagan, during the days of the Soviet Union, set up a Team B to challenge Team A, if you will, on the strength of the Soviet Union.

We are trying to set up a mechanism where GAO and others can—I think the more you are pulling in people from outside to test you, to make sure that what you are doing is exactly accurate, because there is a lot of talent out there, and I do not think the Administration ought to feel funny about taking advice from people outside. But I think the more you are going outside, particularly with the mood shifting in a country, the better it would be.

I guess, if you could maybe just submit for the Commission in a summary form some of the areas that you believe that China is not in compliance with the WTO, and major areas that, if they did come into compliance, what the impact of that may very well be on this problem.

The last issue that Ms. Kaptur addressed, did you have a projection, either of you, of what the trade deficit with China will be? It was $104 billion last year. This year, it is going to be about $120 billion. What are your projections, if nothing changes, for the year 2005, which is just 2 years from now? Do you have any projection for that yet? Well, you really have to do that, though.

Mr. FREEMAN. I know that the Council of Economic Advisers [CEA] does some studies on that.

Representative WOLF. Well, if you could give the Commission a projection. I know it is difficult to go in the out years to 2010, but if you would take the current circumstances the way they are and give us a prediction of what you think it will be in the year 2005.

And the last question is, what impact is this now having, not only on manufacturing, but on the high-tech industry? I am beginning to see more stories about the high-tech. What is the impact that you see China having on the high-tech business community? That is my question.

Mr. FREEMAN. Well, there are two things. I mean, one, if you are looking strictly at semiconductors, for example, China's value added tax policy actually encourages domestic production of semiconductors in China.

What that does is encourage migration of our production to China. That is something which we don't want to see. Again, we have been talking to China extensively about the WTO consistency of their VAT rebate policies.

What we want to do is make sure China understands not only that the policy of VAT rebates may be WTO inconsistent, but there actually are multiple good reasons to maintain imports from the United States of semiconductors for purely economic reasons. So, that is where we are on semiconductors.

I will say that one of the areas that we are profoundly concerned about and which China really needs to stop the words and start producing deeds, is on intellectual property rights, which has impacted not just the high-tech area, but everything from auto parts to Zippo lighters. I mean, if we can make it, they can fake it, quite frankly.

And one of the things that we need to see is China taking steps to not just produce a WTO-consistent IPR regime, a legal regime, but actually make sure that they are creating deterrent-level criminal penalties that put IPR infringers behind bars.

Unless that happens, we are going to continue to see a lot of IPR violations, IPR problems, for everything from semiconductor masking piracy to reverse engineering of our high-tech products taking place in China.

It is something that China's leadership right now seems to understand. At least, they are telling us that they understand the role of IPR in a mature economy. But, very frankly, once you get past that top leadership, it gets real murky.

That is why the leadership has to step up and say, all right, we are going to put criminal penalties in place that are going to put some of you guys behind bars. And we do not care who you are, you are going behind bars if you infringe IPR. That is something that Ambassador Zoellick has been very focused on, frankly.

Representative WOLF. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Are there further questions of this panel?

[No response.]

Chairman LEACH. If not, we want to thank you all very much, and we will turn to the next panel.

Panel 2 is composed of Gary Martin, who is president and CEO of the North American Grain Export Association. Mr. Martin proudly served in the Administration of George H.W. Bush at the U.S. Department of Agriculture, and in the Clinton Administration as advisor to the Special Ambassador to the former Soviet Union.

Mr. Brad Smith is currently managing director for international affairs, American Council of Life Insurers. Mr. Daryl Hatano is the vice president of public policy with the Semiconductor Industry Association [SIA].

Mr. William Primosch is director of the international business policy in the International Economic Affairs Department of the National Association of Manufacturers [NAM]. He is a former career diplomat of the U.S. Department of State. Unless there is a prior agreement with the panel, we will just go in the order in which you were introduced. Is there any disagreement with that?

[No response.]

Chairman LEACH. All right. Then we will begin with you, Mr. Martin.

STATEMENT OF GARY MARTIN, PRESIDENT AND CEO, NORTH AMERICAN EXPORT GRAIN ASSOCIATION, WASHINGTON, DC

Mr. MARTIN. Thank you, Mr. Chairman. I will speak today, as have previous speakers with their comments and the discussion so far today, about agricultural market access issues. That is the entire focus of my association's work, and indeed a passion of my personal career.

Additionally, I ask that you accept my formal comments into the record. I understand that time is short, so I will be as brief as possible in making my comments. I think that you have already seen a demonstration of the importance of the Chinese market and the importance of success in that market.

Chairman LEACH. If I could interrupt for a second. Without objection, the full statements of all panel members will be placed in the record, and you can proceed as you see fit. Please, go ahead.

Mr. MARTIN. Thank you.

I think you have seen a demonstration of the importance of the Chinese market and China's successful implementation of its WTO commitments. The importance to agriculture and the agricultural economy here in the United States cannot be overstated. It is a dominant market force globally. The Chinese agricultural and food system is very important to us.

We have had some successes. Investment has been directed to China. Trade has been directed to China. I would point out that, in the last 5 years, we have seen a quadrupling of agricultural exports to China, much of that as a result of the accession to the WTO.

However, we still have some difficulties. In my testimony, I get into quite a bit of detail about those issues. But I want to point out, in particular, six key issues, and then address some recommendations for progress along these lines. Several of these issues have been mentioned already this morning, so I will keep it short.

The uncertainty regarding biotech regulations is, indeed, a continuing issue. The work of the Administration, and particularly the interest of President Bush in this regard, has resulted in placing us very close to resolution, but we need to close the deal in that regard.

Labeling on meat and poultry products is certainly a major issue for us. Labeling that really does not enhance food safety is a considerable problem in China. The Chinese adherence to the SPS agreement in the WTO, remains very much an open question.

Continuing attempts by the Chinese customs administration to manage trade, particularly import trade, via quarantine measures is a continuing issue and a priority of ours, as well as export subsidies, particularly for corn, and the range of problems we have already heard discussed on the tariff rate quota system.

Our association today asks that the United States aggressively focus attention and improve Chinese compliance with the WTO in three particular areas. We think this is the most bang for the buck and provides the most opportunity in the shortest time.

First, the regulatory practices of the Chinese State Administration of Quality Supervision, Inspection, and Quarantine [AQSIQ]. Second, complete and final elimination of agricultural export subsidies. Third, improvements in the implementation of the agricultural TRQ system.

With respect to AQSIQ practices, current practices are unworkable. We have three recommendations in that regard. The agency should restrict its activities to science-based standards that comply with WTO and international convention; the agency should approve import permit requests in a timely and commercially realistic manner; and the agency should ensure that its operations are transparent.

With regard to agricultural export subsidies, the problem of export subsidies for corn persists in particular. Subsidies have resulted in lost sales of U.S. products in key markets: in South Korea, Malaysia, Indonesia, and even Japan.

With regard to agricultural export subsidies, we have two recommendations. China should formally and fully account for the discrepancy between domestic and export corn prices. Finally, China should immediately meet its WTO commitment and proceed to eliminate officially supported mechanisms that permit exports at lower than domestic prices.

Our final focus has been discussed quite a bit this morning: the agricultural tariff rate quota issue. There are new regulations and new practice being developed now in China that we need to review to ensure that China is honoring its TRQ obligations in a way that provides for transparency and commercially feasible quotas. That is important and needs to be implemented immediately. Again, it was part of their requirements in December 2002.

In summary, much has been accomplished since China's accession to the WTO with regard to its commitments related to agricultural trade. However, U.S. expectations are for additional and more timely progress. The U.S. and Chinese Governments have demonstrated an ability to resolve some outstanding issues.

Given the importance of several unresolved concerns to both China, the United States, and global markets, a renewed commitment and additional effort by the United States, China, and the WTO are warranted. Thank you.

[The prepared statement of Mr. Martin appears in the appendix.]

Chairman LEACH. Thank you very much.

Mr. Smith.

STATEMENT OF BRAD SMITH, MANAGING DIRECTOR, INTERNATIONAL AFFAIRS, AMERICAN COUNCIL OF LIFE INSURERS, WASHINGTON, DC

Mr. SMITH. Thank you, Mr. Chairman, for the opportunity to testify.

I would first like to start off by saying that one of the reasons that the American Council of Life Insurers [ACLI], and our industry counterparts, mainly led by our property/casualty counterpart, the American Insurance Association, were such strong supporters of PNTR for China was because the accession package, consisting of a schedule of specific commitments and the working party report, were extremely good market access and national treatment commitments for our industry.

Having just returned from Cancun and looking at some of the offers on the table from other major emerging markets that are already members of the WTO, and the level of commitments that we are now trying to get them to implement, expectations are very high.

Having done several bilateral implementation measures in insurance liberalization agreements the United States has negotiated with Japan and Korea, we did realize, however, going into this process that no agreement is self-implementing. In the implementation phase, constant monitoring and enforcement pressure is the most important aspect in actually realizing the commercial benefits of any agreement.

Starting this process, I would like to commend the U.S. Trade Representative [USTR], the Commerce, Treasury, and State Departments, and many interested Members of Congress who have helped us establish an ongoing dialog with the Chinese Insurance Regulatory Commission [CIRC] which is tasked with drafting the implementing regulations.

Since China's entry into the WTO, CIRC has drafted five regulations. The first several were very general and did not give a great deal of specificity on how China would live up to its WTO commitments. The U.S. Government, led by USTR and Commerce, has gone back to the Chinese repeatedly on these issues with questions that we have generated and that have been generated by consultants we have retained in China. Our goal has been to try to take away the corners, get positive confirmation on how China will implement her commitments, then proceed, get licensed, and begin operations.

We have several member companies that have operated in China that consider the process exemplary, and that their communications with CIRC are very positive. We have others that are somewhat frustrated with the process. I would just say that, over the last 2 years since the beginning of implementation, we have noticed positive progress in the area of transparency.

The last two regulations that China implemented to address our specific questions with regard to capitalization and branching requirements which we had considered a major market access barrier actually lowered the requirements by two-thirds. Once they are finally adopted and enter into force, we feel they will largely address our concerns on capitalization restrictions in the Chinese market.

Another notable development in the recent release of draft regulations was that they actually were released in draft. The CIRC posted them on its Web site and invited public comment. We provided comments within the time they allotted. We have translated this into Chinese, sent it to USTR, as well as other U.S. Government agencies. Our hope is that, by the end of the year, we will be able to continue a dialog with the CIRC to clarify our concerns and questions.

This has actually worked in the past. Our capitalization issue, we believe, was addressed because of a meeting that USTR and the Commerce Department at the U.S. Embassy in Beijing were able to schedule as a face-to-face between our industry and our regulators in Beijing in December of last year.

We are hopeful and cautiously optimistic that by——

Chairman LEACH. If I could interrupt just briefly, Mr. Smith.

Mr. SMITH. Sure.

Chairman LEACH. Co-Chairman Hagel has come. He is in a meeting with Mr. Bremer on the Iraqi issue and he wants to indicate a vote, and maybe make a comment, if you would like. Go ahead.

Senator HAGEL. Mr. Chairman, thank you very much.

I am, first, sorry that I have missed the panel and the meeting. But, as the Chairman noted, we have had Ambassador Bremer before the Foreign Relations Committee the last 2½ hours, and we go right back into another hearing and I have to go preside.

So, I know they are lame excuses, but, nonetheless, that is where I have been, and I am sorry to miss this. I will obviously catch up along the way and appreciate, as we all do, your presence here, your testimony, your insights.

I think there is little question of the importance of what we are trying to do and what this organization has been about the last 2 years. It is critical that we continue to get your input and your insights into so many of these issues that will have immense consequences in the future for America's relationship with China and all aspects of the world. So, thank you very much for the time that you have taken to come and offer your insights and thoughts.

Mr. Chairman, thank you very much.

Chairman LEACH. Well, thank you. Thank you for your support and for taking time to leave your committee. As you know, Senator Hagel, it is my personal view that about half of the wisdom in the U.S. Senate resides on your shoulders. Thank you for coming.

Senator HAGEL. You are far too generous. But he is from Iowa, so that is probably some explanation. But, thank you very much. And for Congressman Wolf's attention to this Commission over the years. Frank, thank you. You have been a very significant part of this and your contributions have been important. We appreciate it.

Representative WOLF. Thank you. If I could say, I like seeing you on television because you always tell the truth. When the show is over, you always know precisely where you stand. A lot of times I agree with you, so I wanted to comment. I saw you at the summit.

Senator HAGEL. Thank you.

Chairman LEACH. All right. Thank you, sir.

Please proceed, Mr. Smith.

Mr. SMITH. Thank you. I would conclude just by saying that we think this is the beginning of a process. We have had extensive bilateral negotiations or a follow-on on implementation through USTR and other U.S. Government agencies.

We have also worked to mobilize a coalition of our competition overseas. The European, Japanese, and South Korean insurers that have operations in China have similar concerns.

At the Geneva transitional review mechanism meetings and the Committee on Trade and Financial Services, the United States has found itself in an admirable position of leading a charge of five or six governments that all have similar questions on insurance matters.

To the extent that we can continue to coordinate the pressure from international counterpart organizations to try to make sure that China fully implements its commitments, we think that just adds strength to the effort.

As I say, this is the beginning of the process. We will look forward to getting back to this Commission and to interested Members of Congress on the outcome. We have some regulations that we just commented on in July and August. They are fundamental to establishing the criteria under which companies can expand in China. We have provided detailed comments and we sincerely hope that those comments are taken into consideration. We look forward to reporting to you on that by the end of the year. Thank you.

[The prepared statement of Mr. Smith appears in the appendix.]

Chairman LEACH. Good. Thank you, Mr. Smith.

Mr. Hatano.

STATEMENT OF DARYL HATANO, VICE PRESIDENT OF PUBLIC POLICY, SEMICONDUCTOR INDUSTRY ASSOCIATION, SAN JOSE, CA

Mr. HATANO. Good afternoon. My name is Daryl Hatano, and I am testifying today on behalf of the $70 billion U.S. semiconductor industry, which is America's largest manufacturing industry.

This morning I would like to follow-up on two points that Deputy Assistant USTR Charles Freeman made in answer to your question, Mr. Wolf, with regard to the value added tax rebate program on semiconductors in China and on intellectual property enforcement.

But before turning to these issues, I would like to first note the progress that has been made since China joined the WTO. Over 80 percent of China's chip market is met by imports. The U.S. industry was a major beneficiary of China's elimination of semiconductor tariffs last year.

The United States has also made progress in resolving two WTO implementation issues, one related to a trade barrier that had prevented China's participation in the Information Technology Agreement, and the other related to product coverage under China's semiconductor intellectual property protection laws.

SIA appreciates the efforts that USTR and the U.S. and Chinese Governments have made to resolve those two issues, and we are hopeful that the momentum that we have built from that can carry over into the value added tax rebate program and the intellectual property issues that I would like to turn to next.

China currently imposes a value added tax [VAT] of 17 percent on semiconductors, regardless of whether they are imports or domestic production. However, China will rebate to domestic producers the amount of that VAT that is above 3 percent of sales. So, basically it is a discriminatory policy that favors domestic production over imports.

This discrimination violates GATT article 3, which prohibits countries from imposing taxes on imported products that are greater than those imposed on domestic products.

To comply with the WTO, SIA believes that the best policy for both U.S. export interests, as well as China's economic development, is for China to lower the VAT on imports; that is, to have the same VAT level for both domestic production as well as imports at the lower level that they have announced.

Many in Congress agree with our conclusion. Earlier this year, members of both the House and the Senate, including four mem-

bers of this Commission, sent letters to Ambassador Zoellick urging him to vigorously insist that China abide by its WTO commitments and lower its VAT on all semiconductors.

This is also not just a U.S. issue. In May, the CEOs of the chip industries in the United States, Japan, Korea, Europe, and Taiwan came together under the banner of the World Semiconductor Council and proclaimed that China's VAT policy "has the effect of limiting market access, distorting patterns of trade and investment, and negating the benefits China promised to provide when it joined the WTO."

As a result of this attention, China has formed a research group to reexamine the VAT issue. In my recent meetings in China, we sensed a willingness in some quarters to explore alternatives with the United States. However, in other quarters there was continued skepticism that changes were necessary. The U.S. Government must continue to insist that China quickly come into compliance with its WTO obligations.

The second key issue I would like to cover today is the enforcement of intellectual property. SIA is aware of numerous reports of IP violations in China. In one case, an SIA member company found that Chinese firms were making identical copies of its chips and data sheets and selling it under the Chinese companies' names. The chips were essentially photocopies of the U.S. design, and even included the same unused circuits that the U.S. company had put on the chip to reserve space for future product development.

The Chinese firms that engage in piracy are typically thinly capitalized companies that rely on foundries to actually manufacture the product. These foundries are the ones that are able to afford the multi-billion dollar investments that are required in our industry.

The court system in China is still developing, and U.S. firms are concerned about the fairness of their procedures. China also has administrative enforcement mechanisms, but these are largely untested. The Chinese Government has expressed a willingness to work with the United States to improve its IP enforcement.

It is worth noting that IP enforcement is critical, not only to U.S. firms doing business in China, but also in China's self-interest, as it will encourage foreign high-tech investment in China, as well as encouraging local innovation in China.

SIA urges the U.S. Government to devote the necessary resources to address the many technical issues in China's IP enforcement procedures.

China is a large and growing market. While the challenge of the transition from a planned to a market economy is immense, we are encouraged by China's progress and the commitment demonstrated by Chinese Government officials in our recent meetings. We look forward to continuing to work with the U.S. Government to further China's movement toward implementing its WTO commitments. Thank you.

[The prepared statement of Mr. Hatano appears in the appendix.]

Chairman LEACH. Well, thank you, Mr. Hatano. I think you have not only set a record for staying within the time limit, but for someone with so many degrees, including an MBA and a law de-

gree, that is particularly impressive. Usually, the longer the number of degrees, the more discursive. So, thank you.

Mr. Primosch.

STATEMENT OF WILLIAM PRIMOSCH, DIRECTOR, INTERNATIONAL BUSINESS POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. PRIMOSCH. Thank you, Mr. Chairman, for giving the National Association of Manufacturers [NAM] an opportunity to testify on a subject of great interest to our members.

I can tell you that we hear more from our members about trade with China than with any other foreign country. In fact, Mr. Chairman, at our meetings of the NAM board yesterday afternoon and this morning, China trade concerns dominated our discussions.

Trade with China is of immense importance for U.S. manufacturers because China is both a large, rapidly growing market for U.S. products, and at the same time a fierce competitor in the United States and global marketplaces.

As China concludes its second year as a WTO member, however, its compliance record is decidedly mixed. The NAM has received far more complaints about Chinese trade practices this year than in the previous year.

In a recent survey, our members identified a variety of policies that have provided Chinese exporters with unfair trade advantages and created significant non-tariff barriers that hindered market access, and many have been mentioned already by my colleagues and by members of the Commission.

At the top of the list is currency manipulation and China's deliberately undervalued currency. In the view of many manufacturers, China's undervalued currency is the single most important factor driving the growing trade imbalance between the United States and China.

Economists have estimated that China's currency could be undervalued by 40 percent or more. As of July, China had accumulated more than $350 billion in foreign exchange reserves. This is far in excess of what IMF analysis indicates is necessary, and a clear indication of currency undervaluation.

Another concern relates to subsidized exports. We continue to receive reports from different industries that Chinese products are being sold in the United States at prices so low, they could not cover the cost of raw materials and shipping, much less full production and marketing costs. These reports suggest the possibility of widespread use of subsidies, either direct, or very likely indirect.

A third major concern was mentioned by other panelists, and that relates to counterfeiting and intellectual property rights violations. Violations of trademarks through product counterfeiting is rampant on a truly massive scale, and is within the knowledge and purview of both local and national government authorities.

While Chinese laws on intellectual property rights protection have improved considerably, the lack of effective enforcement of IPR protection remains a serious problem.

Other problems were noted by our panelists, and they have also been noted to us at the NAM: value added tax discrimination; problems with standards and the application of the CCC Quality Mark

System; failure to implement automobile financing regulations that were promised under the membership agreement, and resistance to allowing U.S. companies to have export and import rights as required under market access pledges.

In short, Mr. Chairman, we see a variety of unfair practices that are impeding U.S. exports to China and providing Chinese products with competitive advantages in the U.S. market.

The Commission has asked for policy recommendations for changes, things that could be done better. We have a few suggestions. But, first, we would like to say that U.S. agencies, particularly the Commerce Department, Treasury Department, and USTR have been making good efforts to advance U.S. trade interests and deal with a lot of these problems.

The scope of the challenges, however, requires a much larger scale effort than currently exists. The NAM recommends the following five-point action plan:

First, compliance with WTO trade rules and market access commitments are critical for creating a level playing field. Commerce and USTR need additional staff to monitor, and more importantly investigate, WTO compliance concerns. Current resources are not adequate to do the job right.

Second, we must continue to press China to end the manipulation of its currency and to allow the yuan/dollar exchange rate to be determined by market forces. Secretary Snow's visit was an excellent start, but we need to keep the pressure on China and we need to involve our other trade partners, particularly the G–7.

The NAM is prepared to support a section 301 trade complaint in concert with other members of the Sound Dollar Coalition as a way of underscoring the seriousness of this matter.

Third, we must effectively address subsidized and non-market based production. Fourth, we must take firm action to end China's rampant counterfeiting and violations of intellectual property rights and use trade action when necessary.

Finally, and I would like to thank Congressman Wolf for his support and interest in this, we need to support a much larger scale public-private sector trade promotion effort to increase U.S. exports to China.

In 2003, China will become the world's third largest importer, with $380 billion in imports. We will only get 8 percent of that import market. We can do better than that. Thank you, Mr. Chairman, for giving me the opportunity to testify.

[The prepared statement of Mr. Primosch appears in the appendix.]

Chairman LEACH. Thank you, Mr. Primosch.

I want to just ask one question, and it is of you, Mr. Primosch. It relates to your very last phrase and the 8 percent issue of U.S. participation in exports to China.

Does the NAM, or does anyone in our government, keep statistics on the relationship of the U.S. trade deficit in contrast, most particularly with the European Union, but with other parts of the world? For example, we have about a $400 billion deficit this last year in trade. What is the EU's? What is the relationship of their exports and imports?

It strikes me, there are two very interesting general statistics. One, is the statistic of what China imports from us relative to what

we import from them. Second, what China imports from us relative to comparable groupings of societies. For example, the EU, in relationship to what the EU imports from them.

Do you have those figures?

Mr. PRIMOSCH. I have some of the statistics, Mr. Chairman.

Chairman LEACH. Go ahead.

Mr. PRIMOSCH. I think you have raised a very interesting point. The European Union exports about 50 percent more to China than the United States. The European Union imports considerably less from China than the United States. I do not have that exact figure.

But what is interesting is that, I think, particularly in manufactured goods and in machinery, for example, the European Union exports about $7 billion more than we do. It is not quite clear why they are able to do that.

Someone earlier in our discussion mentioned standards.

Chairman LEACH. Mr. Bereuter. Yes.

Mr. PRIMOSCH. Is this because European governments support their businesses more? That is an issue. I think there is more support by their governments of export promotion. That is an issue. They are much more supportive of their companies in China. And I think we also have to admit that many European companies, and particularly smaller companies, are more export oriented. They perhaps put a little more effort into it. That is something that U.S. manufacturers can learn from that as well. So, I think it is a variety of factors.

Chairman LEACH. Yes. To the degree that there is a managed trade element—and there is—now, there is a free aspect of trade with China that goes on, and we understand that. There is a managed element that goes on and we somewhat understand that. Should we be expecting China to be importing comparably at least as much from us as they do the EU? Is that a reasonable expectation of the United States?

Mr. PRIMOSCH. I think that is a reasonable expectation. Particularly now with the decline of the dollar against the euro, we would expect to see more exports to China from the United States in a lot of these manufactured goods areas than from the European Union. So, yes, I think you are correct on that, sir.

Chairman LEACH. Thank you very much.

Sandy.

Representative LEVIN. Thank you. Thank you for your excellent testimony.

Let me just say a word about the WTO compliance and the use of the annual review. Each of you come from somewhat different sectors. Do you feel there is enough interaction between yourselves and our government as it prepares for these annual reviews? The second one is now under way, or will soon be under way.

It is one forum, an important forum, for us to raise these issues, to press these issues, to secure support from other countries so it is not simply the United States and China.

So, what are your thoughts about that? Is there enough back and forth? Are you enough of a participant? You think you are?

Mr. MARTIN. With respect to the WTO annual review?

Representative LEVIN. Yes. Exactly.

Mr. MARTIN. Yes. I think that the interaction between the agricultural community, USTR, and USDA, in particular, is sufficient. They have identified the issues clearly and have taken them forward to the WTO process. I do not see any gaps in understanding what the issues are and where we're at.

Representative LEVIN. But how about the intensity of our pressing them?

Mr. MARTIN. I think that is a matter of resource allocation. I agree with the previous comments, there are not enough resources there today to deal with the size of the market that China represents.

Representative LEVIN. All right.

Mr. PRIMOSCH. If I could make an additional comment. I do think we have very good cooperation with both the Commerce Department and USTR. They do welcome our input, and they make themselves available.

In fact, there will be a hearing on October 3—probably many of us will be testifying there. We have provided a detailed report on China's compliance to USTR, and we will have an opportunity to make additional comments at the hearing.

However, I do think that many of the issues that we have identified are resource-intensive issues. When you get into issues like standards or intellectual property rights, for example, of automobile parts that are being counterfeited, you need to do investigative work and really pin down where this is happening and follow through. Clearly, there are not enough resources for that kind of intensive investigation and follow-up, in our view.

Representative LEVIN. That is important. Mr. Wolf, my guess is, has taken note. We should not short-change this annual review. We work to have it occur and we have got to make it meaningful. I think China needs to realize that it is an important forum, and it can be a constructive effort. So, that is point one.

Second, I just want to mention, in terms of the currency issue, I just want to refer again to article 15, paragraph 4, because there are some who question whether there is any relationship to the WTO.

That article 15, paragraph 4 prohibits WTO members from using "exchange action" to "frustrate the intent of the provisions of the WTO." So, it seems to me there is a clear basis for our utilizing measures within the trade ambit relating to currency valuation.

The last point regarding counterfeiting of intellectual property. I think when people hear that, they think mostly about movies. That is the most common one. Because when you go to Beijing, as I have, you walk down the street and pretty soon somebody says, "Would you like to buy a CD, now a DVD?"

But is it not a larger problem than that? Does it not relate to manufacturing and the products that are made? Do any of you want to comment on that?

Mr. HATANO. Well, it is also a semiconductor problem. We have the sort of problems where they are copying semiconductor chips. We can use the term "counterfeiting," but from a legal perspective it can be a violation of the semiconductor mask work law, similar to what we have here in the United States, because it is illegal to just copy the designs of a chip. It is also a violation of copyright

law because they are often copying our data sheets and other things that go with that, and any software that is accompanying the chip. It is also a violation of trademarks, because they are selling it under our name.

There is also a consumer fraud element because effectively what they are doing is trying to get the customers to think that it is a U.S. product with U.S. reliability behind it. So, there are a lot of aspects to it and it is something that is one of our highest priorities.

Representative LEVIN. Yes, Mr. Primosch.

Mr. PRIMOSCH. May I just add to that? Congressman, you are absolutely right. This is not just a problem with films or CDs. Virtually every manufactured product or consumer good has been counterfeited in China, from footwear and health care products to pharmaceuticals.

I have even heard from a representative of the auto industry of an entire automobile that was counterfeited. This is a very serious problem for a wide range of manufactured products and it has many dimensions.

For example, with pharmaceutical products, the counterfeiting of medicines has implications for public health. In fact, counterfeit medicines have been identified as one of the most serious public health problems in China. So, yes, it is much broader than just films or CDs. It affects a wide range of manufactured products, particularly in the auto industry.

Representative LEVIN. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Wolf.

Representative WOLF. Thank you, Mr. Chairman. I have a meeting at 12:30, but I just wanted to make a couple of comments for the record, and ask you a question.

The EU does better. Germany actually has a trade surplus, not a trade deficit. Frankly, I think part of the responsibility of the business community has been very complacent. You all have been so complacent. I think some of you—and I am not addressing you four, I am talking in general—have been very reluctant to speak out. It is like you are afraid. You are afraid the Chinese will prevent you from doing business.

I think you have actually been part of the problem, in the sense that you have not been assertive—now, I sense that is changing. I appreciate the NAM taking the leadership that it has been taking lately. But I think that you have been very reluctant to be bold, to speak out. You have been very reluctant.

For some of you—again, I am not speaking to the four of you—in the industry, it will be too late. For garlic, it will be too late. The garlic industry will, for all practical purposes, go. California will no longer be the big garlic producer.

Apples. The apple industry is precarious. As this moves, applesauce now coming in, now apples. As you cut down those apple trees, the subdivisions go up. So, for apples, it could be at the end point.

So, I think the fact that you are beginning to speak out is very healthy. And I do not want to get into how this is a country that is a godless, Communist country. I think you have to realize that.

I mean, Ronald Reagan's finest speech was when he called the Soviet Union "the Evil Empire," because he called it what it was.

I think now the Administration is beginning to kind of catch the vision. They are concerned politically. I think they now have had these series of meetings and know how serious a problem it is.

I think you all should push. Why would we not bring a VAT case with regard to the violation that you mentioned, Mr. Hatano? Why would you not insist? This is your government. These are people who are working for you. So, you should insist. The industry in my area, the Manassas facility which you may or may not be aware of, has lost a lot of jobs that have gone out. So, you should insist. This is your government. This is not something that you should be fearful of. They should bring the case.

Just very quickly, I want to ask you this. I read this article in today's National Journal. It says, "Officials from the National Association of Manufacturers and the AFL–CIO"—that's an interesting combination, when you get those two together—"now expect to ask the White House to begin a so-called section 301 investigation into whether China is maintaining an unfair trade advantage by keeping its currency artificially strong."

Just yes or no. I know where you are now, but do you think that there should be a case brought? One.

Mr. MARTIN. On the currency issue?

Representative WOLF. Yes.

Mr. MARTIN. I think that the Chinese approach to currency valuation is inappropriate and needs to be changed. Whether or not the 301 case is——

Representative WOLF. By bringing the case, that would not be a protectionist act, would it? It would seem, based on what Senator Levin said, it would not be. The law requires, as you get into a case, that we have a law and we can work within that law. So would you think that would be a violation or a protectionist act for us to bring a case with the NAM?

Mr. MARTIN. Section 301?

Representative WOLF. Yes.

Mr. MARTIN. I am not an expert in trade law.

Representative WOLF. No. But, I mean, from your own——

Mr. MARTIN. I think that it sounds logical. I think that our standard for all of the actions that we contemplate against China is what will be the most expeditious.

Representative WOLF. And if this were solved, this would help you tremendously.

Mr. MARTIN. If it does it in a timely fashion and something else would not be a better alternative.

Representative WOLF. Mr. Smith, do you think this should be a case? Be bold, now. Just tell us honestly. If you do not think so, say so.

Mr. SMITH. We do not actually produce stuff in the United States.

Representative WOLF. No, but you insure people who do, though.

Mr. SMITH. Our companies actually set up operations in China and then repatriate the profits.

Representative WOLF. So you are neutral then. All right.

Mr. SMITH. Yes.

Representative WOLF. Mr. Hatano.

Mr. HATANO. We have not taken a position on the currency issue. We want to make sure that whatever currency exchange rates there are are the right ones, and we support and applaud the efforts of the Administration, and NAM, and others who are taking the lead on that. But we have not taken a position on what the right mechanism ought to be to get there, or what the right level is.

Representative WOLF. But the Chinese have no reason to give unless they are forced to give. I mean, that is business.

Mr. HATANO. Yes, I certainly understand that.

Representative WOLF. They are very tough people. I mean, the long march that Mao took. This is not a day care facility manager. These are very tough people.

I do not want to abuse my time. I think you should take a position. If it is no, it is no. If it is yes, then yes.

Mr. HATANO. If I can touch on your question on the VAT.

Representative WOLF. If the Chairman will allow.

Chairman LEACH. Go ahead.

Mr. HATANO. The semiconductor industry has been very aggressive with trade actions in the past. In the Japan case, I think it is fair to say that we were the first ones to really use 301, when we were at that time being advised not to really file a case because it was something one threatens to use rather than uses.

Representative WOLF. Advised by whom?

Mr. HATANO. The U.S. Government. This is back in the 1980s, with Japan. I am just saying that we have been very aggressive when we have needed to be. With regard to the VAT, I think we have tried to take a very reasonable approach and talk with the Chinese, make sure they are fully aware of what the problem is, and make sure that they are actually trying to deal with it.

But we will cross the bridge when we get there in terms of filing a case. I am just emphasizing that we have not been shy in the past.

Representative WOLF. Well, some of those jobs will no longer be here, though, if you take too long to cross the bridge.

Mr. HATANO. I understand.

Representative WOLF. I think you have to deal with that.

And I want to commend the NAM. I think you all have really been providing the leadership. I think, this is your government. I mean, Ambassador Zoellick is a good man. I think he is a constituent, lives in my district. Good man. He works for you. You pay his salary. We all work for you. We are public servants. We are supposed to give you the best judgment.

But I think it is appropriate for you to push your government to be responsive. I think, for a long period of time, it has not been. Now I believe that it is. And now that it is, I think this is not the time to let up. This is the time for you to be aggressive and to push, because I think this is something that can be done.

I think, quite frankly, there is probably a representative of the Chinese Government here writing down everything. This government will fall. This government will fall. And when it falls, it will be chaotic, so there will be an opportunity for the people of China to live in freedom, for Catholic bishops to give Holy Communion,

for Tibet to be free. It will fall. It will fall and it will crumble and they will pull the people out of the palaces and wherever they are in Beijing and they will be held accountable. So I think the more you are pushing, the sooner we can bring freedom, democracy, and opportunity and openness.

But the way to do that is the way that Ronald Reagan did it, by being bold, by standing for our values, by articulating, and not being mean, not being aggressive, not being rough, not being rude, but bold. So, I think it is time for the industry—and I think you are now beginning to do that—to be bold. When you are bold, this government will collapse. There will be freedom. There will be opportunities. But it will not come as fast if you do not push.

I appreciate you being here, and I thank the Chairman for the extra time, and yield back. Thanks.

Chairman LEACH. Well, thank you very much. I thank this panel. I would indicate, Frank, that there are expected votes on the House floor in the near future.

Representative WOLF. I am going to a meeting on the House side.

Chairman LEACH. All right.

Do you have any further questions, Sandy?

Representative LEVIN. No, thank you.

Chairman LEACH. Then we will move to the next panel, which is the distinguished panel of academics. It is composed of Lawrence J. Lau, who is the Kwoh-Ting Li professor of economic development at Stanford University; Margaret M. Pearson, who is professor of government and politics at the University of Maryland; and Yasheng Huang, who is associate professor at the Sloan School of Management at the Massachusetts Institute of Technology.

We welcome the panel. Again, unless there is a prior arrangement, we will proceed in the order in which the introductions were made.

Professor Lau.

STATEMENT OF LAWRENCE J. LAU, KWOH-TING LI PROFESSOR OF ECONOMIC DEVELOPMENT, STANFORD UNIVERSITY, STANFORD, CA

Mr. LAU. Thank you, Mr. Chairman, distinguished commissioners, ladies and gentlemen. It is a great honor for me to have the opportunity to testify before your commission. I have some written testimony. May I request that it be submitted for the record?

Chairman LEACH. Let me be very precise. All statements will be fully presented in the record, if there is no objection. You may proceed as you see fit. If it is at all possible, we would like summaries.

I know that is very difficult from the academic arena. We do have an awkward situation of intervening votes. So, please proceed, Professor.

Mr. LAU. Thank you very much. I will try to be very brief.

First of all, I would like to say I really endorse the discussion about the intellectual property rights issue. I believe that if it actually can be pushed successfully, that it would really greatly increase the exports that we might be able to send to China.

But I want to mostly focus on the currency situation and on the trade balance. I think one of the things that I would like to point

out is the following: Although China has a very large surplus with our country it actually has a deficit with the rest of the world. So, the aggregate total of the Chinese surplus with respect to the world is actually not very large. The estimate this year, 2003 is expected to be around $10 billion worldwide.

Now, when one contrasts this with the Japanese experience, Japan has a large surplus with us, about $80 billion in 2002, or $60 billion, depending on whose numbers you use. But Japan actually has a very large surplus with the whole world. It is about $80 billion.

So, if there is any disagreement, it is really very much on the Japanese side, because the Chinese side on current accounts, is actually pretty close to balance. Now, of course, this does not detract from the fact that we have a large deficit with China.

The second point I would like to make is that if you really look at the Chinese exports to us, the value added component is actually very low. It is about 20 percent. That means, for every dollar that they ship to us, the contribution in China is only around 20 cents.

Now, why is that the case? That is the case because Chinese exports consist mostly of what we call processing and assembly activities, which means that they take what other people have built, they make goods out of other people's components and then they ship the goods to us. So what they are doing is really final finishing and assembly.

There are two implications. One is that the value added, the gain that they get from these large exports to us, is actually not that large because a lot of it actually goes back to Japan, South Korea, Taiwan, and ASEAN countries.

With all of them, China actually is running a huge deficit because they are taking their parts and components and they are just putting them together, but they all come here to be sold and the total counts as Chinese exports. So, I think we need to take that into account.

But the true implication of that is the following: The currency movement would not be very useful. I actually support very much Congresswoman Kaptur's opinion that the problem is not the exchange rate.

But here, the way to think about it is if the import content is 80 percent, if you appreciate the value of the currency, what it does is it makes the imported material cheaper, although it makes your part more expensive.

So, I have done the calculations and, basically, a 10 percent revaluation would only increase Chinese export prices here by 2 percent. It would take a draconian increase in the exchange rate to make any dent at all.

Now, to convince ourselves that the exchange rate does not really matter, all we have to do is to look at the Japanese example. From 1960 to now, we have actually managed to push the yuan up from 360 yuan per dollar to, I think yesterday it was about 112, a huge appreciation. Has it made any difference? No. I mean, basically the trade deficit continues and it is just about as large as before.

I think, fundamentally, what we need to do is to change the mind-set, change the Chinese mind-set, that they ought to start importing from us. We should look at the results. The results ought

to be that these countries should have overall balance with the whole world and, therefore, would not take unfair advantage.

Now, if in fact Japan could have balance with the whole world, that means they would have to import $80 billion more and the United States would actually be a beneficiary if, in fact, imports could be stepped up.

So let me take 1 minute to make one final point. I really endorse the Chairman's position, as well as others, that the exchange rate ought to be market determined. But in the Chinese case, we need to do it very carefully because we know that there still exist capital controls. That means that there are a lot of buyers for dollars in China who are not allowed to buy. Chinese citizens cannot freely buy U.S. dollars.

Now, if, in fact, we open it up, I think the currency rate might well come down rather than go up, if capital controls were removed. It is not just on my authority, but Dr. Nick Lardy, who is a very distinguished economist working here at the Institute for International Economics, as well as Dr. Stephen Roach, who is also well-known, both told me that they would expect the Chinese currency to go down if capital controls were removed.

Now, if capital controls were not removed, we really do not have a free market because lots of people are being excluded. So, I think that is really something that we need to think through.

I think we are right to push the Chinese Government to a more market-based mechanism, but I think we ought to take a look at the sequencing, how that can be done in a way that is actually beneficial to us, as well as beneficial to the Chinese.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Lau appears in the appendix.]

Chairman LEACH. Well, I want to thank you for one of the most interesting 4 minutes of macroeconomics I have heard this year. That is extraordinary.

Ms. Pearson.

STATEMENT OF MARGARET M. PEARSON, PROFESSOR OF GOVERNMENT AND POLITICS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD

Ms. PEARSON. Thank you for inviting me to speak in this discussion. I have submitted written testimony that talks about two topics. One is the evolution in year two of China's WTO implementation toward rule of law commitments. I am not going to speak about that in my oral testimony.

But I will speak about the second topic that I am writing about, and that is a somewhat different perspective than we have heard in this forum previously, but it does relate to rule of law issues.

This is to ask the question, "Is China, now that it is a member of an international organization, and responsible for ongoing and future regulation of trade and foreign investment, playing by the rules of that international body in Geneva at the international level?" Now that we are nearly 2 years into the process, it is useful to evaluate China's behavior in this regard.

Prior to engaging in any assessment of this, though, I think it is very important to highlight a distinction about the use of the terms "cooperation" and "playing by the rules." It is very important

that we not conflate the notion of cooperative behavior with adherence to the U.S. Government agenda in WTO.

While, of course, we may strongly prefer that China's agenda in the Doha Round is aligned with the preferences of the U.S. Government, playing by the rules in this body really must be measured in terms of whether a country abides by the norms and rules of the organization as a whole.

Cooperation cannot be defined by the absence of conflict with other nations, since conflicts over trade interests are assumed and built into the process. Indeed, as Mr. Freeman said this morning, the whole reason, or a big part of the reason, why we wanted China to join the WTO, is so we had a place to take disputes, just as we have a place to take disputes with some of our best trading partners and political allies.

My bottom line answer as to whether China is playing by the rules in this forum at the international level, is that it has, by and large, played by the norms and rules of the organization. The Chinese have made no strong effort to change the conservative consensus rules, and it accepts the informal norms of consultation in the organization. I do expand on this in my written testimony, and will refer you there.

Chairman LEACH. If I could interrupt for a moment.

Sandy, there are two votes pending. They are both important votes in the House. They are of a substantial nature relating to homeland security. What I suggest, Sandy, is that we recess and return.

Representative LEVIN. All right.

Chairman LEACH. So that the panel in the room understands, it will probably be a full 15 to 20 minutes. I apologize to each of you for that, but we are obligated to vote where we can.

Representative LEVIN. We made it by 6 seconds last time.

Chairman LEACH. Right. Thank you.

[Whereupon, at 11:56 a.m. the hearing was recessed.]

[The hearing was reconvened at 1:21 p.m., Chairman Jim Leach presiding.]

Chairman LEACH. Well, I apologize for the recess, but the Commission will reconvene.

Ms. Pearson, you were in the middle of your testimony. Please proceed.

Ms. PEARSON. Thank you.

I had just finished saying that my bottom line answer to this question of whether China plays by the rules in the WTO at the international level, meaning in Geneva and in other international forums, is basically that it has.

Mr. Freeman, this morning raised the issue of the TRM, the transitional review mechanism. Indeed, it was very prickly last year. That is an area where China has skated close to breaching some of the norms of what is expected, although I agree with Mr. Freeman that things look much better for this year.

The second area where China's behavior is more questionable, is on the issue of Taiwan. This is not a surprise, certainly, to anybody who studies China's role in international organizations. I think there is not much that is going to change there, but this is considered par for the course and is generally tolerated.

I wanted to speak just for a moment about China's role in the Group of 22 at Cancun in the Doha Round negotiations 2 weeks ago, though, because it has received quite a lot of attention.

I believe that, if we were to listen to the headlines which tell us that China is leading, along with India and Brazil, the Group of 22 to tear apart the negotiations at the WTO, this would be somewhat misleading, and I want to provide some analysis of that.

I confess that China's participation in this Group of 22 took me somewhat by surprise in light of China's earlier expressions of its interest in agriculture, and when, particularly on tariffs, they expressed quite a lot of commonality with the proposal put forward by Ambassador Zoellick and Secretary Veneman last year.

However, when you dig deeper into the issue, several points become clear. Let me, just for the sake of time, list them briefly.

China did, of course, lend quite a bit of weight to the G–22 initiative and gave voice once again to its commitment to building a bridge with the developing world. But if you look carefully, China was not an active leader of this action. Brazil and India were much more important, particularly Brazil.

Commerce Minister Lu Fuyuan's comments in Cancun were designed to be quite conciliatory, in great contrast to the confrontational statements by the other ministers there. Indeed, it was quite clear that China did not wish to see the talks break down or to alienate any other party.

Moreover, statements in the Chinese press about the meetings and about China's participation in this coalition of developing countries have been mostly absent. Stories on the meeting have been very descriptive and simply expressed hope in moving talks ahead.

There is no attempt to gain domestic leverage, to say that, China is standing up tough to the United States and to the WTO and to the developed countries. That is absolutely absent in the Chinese coverage of it.

So, I will just leave you with the thought that, as has been my impression earlier about China's basic willingness to play by the rules of that international organization, the events in Cancun really do not breach that basic conclusion. Thank you.

[The prepared statement of Ms. Pearson appears in the appendix.]

Chairman LEACH. Thank you very much, Ms. Pearson.

Mr. Huang.

STATEMENT OF YASHENG HUANG, ASSOCIATE PROFESSOR, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Mr. HUANG. Thank you, Mr. Chairman, for giving me this opportunity to testify about a very important issue in Sino-U.S. relations, as well as an important issue in China's political and economic transition to a market-based economy.

I sat through the previous two panels. It is an extremely educational experience for me. To some extent, it reminds me of the many conversations I had with Chinese managers and Chinese officials, and they were equally, if not more, mortified by the prospect of competing with companies from the United States, companies from Europe, companies from Japan after China agreed to the WTO terms.

They were extremely worried about the fact that the state sector is doing horribly. They are laying off workers on the magnitude of 30 to 40 million since 1996. They attribute a lot of that to the fact that the Chinese market is saturated with foreign-brand products. They looked at the products that they produced in the 1980s, and many of these products disappeared. In their place were a lot of foreign products.

So, it is very interesting to hear their sentiment about this issue and compare that with the sentiment being expressed here. I think the truth is probably somewhere in between, and there must be a constructive solution to these very difficult problems.

Let me just raise three points to summarize my written statement. The first point, is that China acceded to the WTO agreement in 2000–2001, at a time when its economy was actually very open to trade and to foreign investment.

By any conventional measures, China's economy is actually quite open. The trade/gross domestic product [GDP] ratio is about 40 percent, in comparison with 20 percent for the United States and 20 percent for Japan. Foreign direct investment [FDI], as a percentage share of domestic investments in the 1990s was 16 to 17 percent.

Now it is coming down quite a bit in the last two years. That compares with about 6 percent for the United States. So, this is a country that has no formal investment barriers, and yet the FDI plays a much smaller role in this economy as compared with what we normally would call a Communist-controlled economy.

If you look at other measures, you see this sweeping presence of foreign firms in the Chinese economy. More than 50 percent of Chinese exports are actually produced by companies that are either affiliates or 100 percent subsidiaries of foreign firms, and some of them are American firms.

Of these foreign affiliates, foreign ownership share of the equity of these firms is extremely high. Foreign dominance in the Chinese industries cuts across the board in many industries rather than just in a few sectors of the economy.

So, here we are talking about an economy that, by these measures, actually is quite open to foreign trade and to foreign investment.

The second point that I want to make is that this kind of openness is actually quite unusual, for two reasons. One is that compared to domestic trade in China, foreign trade is increasing. Domestic trade, as a percentage of GDP, is actually decreasing.

Second, there are a lot of barriers. There are barriers toward foreign firms investing in China, but there are also a lot of barriers established basically to reduce the investment potential of the Chinese companies. These Chinese companies specifically are domestic private firms. In fact, I would argue that an average domestic private company in China has a tougher time navigating the Chinese bureaucracy and navigating the Chinese legal system than a typical American company in China.

The third point I want to make is this high FDI inflow into China, and a high trade/GDP ratio, are in part driven by the inefficiencies of the Chinese financial and legal systems.

They are not a sign of an open policy toward foreign firms, trading with and investing in China. They are a product of the fact that

the Chinese Government treats domestic private firms in a worse manner than it does the foreign firms.

But in the last 3 years as China began to implement some of the WTO provisions, and at the same time the Chinese Government began to step up the implementation of internal reforms, the role of foreign direct investment was decreasing in China.

In the mid-1990s, it was about 6 percent of GDP. Today, it is about 4 percent of GDP. So I would argue that, as China begins to reform its economy at a structural level, in fact, you will see more Chinese competition from China than you do now.

Finally, I would just echo the argument made by Professor Lau. I do not think it is a currency issue. It is far more complicated and more difficult. There are far more complicated and more difficult reasons than the simple issue of currency. Thank you.

[The prepared statement of Mr. Huang appears in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Huang.

Mr. Levin.

Representative LEVIN. Thank you for your patience. We are really sorry that you had to wait, and also very sorry that everybody was not here to hear your testimony.

I hope that there will be much more exchange between the three of you and all of us, because each of you brings a perspective that we need to hear and we need to have some discussion about them.

Professor Lau, I think that your view of this needs to be very much in the mix of our discussion and we need to find ways to have some exchange between you and other economists who disagree with you, because this is not a simple issue.

For example, as you minimize the currency impact of the currency picture on page 4, you talk about the yen depreciating from 360 in the early 1960s to its current 115. If you would, or maybe we can obtain this otherwise, I wonder what it was in 1995.

Mr. LAU. It was probably around 240, would be my guess. I think somewhere between 240 and 250, would be my guess.

Representative LEVIN. But also I think you would have to look at, in terms of the impact of currency valuations, the impact in specific sectors. The fact that it has a deficit with other countries does not exactly answer the impact on the United States.

There is not time, I think, to talk about this now. But what I would like to do is to send to you a series of questions, all right? Because we need to hear this. What you said is somewhat counter to what may be the new conventional wisdom on the Hill.

Then we were also glad to hear the testimony from Professor Pearson. Let me just say a word about the TRM. We are kind of by ourselves here. But I wanted to comment on your comment about how it is received in China.

I think what you have said, Mr. Leach, means that we have to try to communicate to the Chinese Government, why the annual review? Some of us on this panel are in part responsible for it because it was placed in our legislation. It is unique to China, but that was because of the unique circumstances of China's accession, both in terms, as you point out, of the lack of compliance in advance, but I think even more importantly was the size of the Chinese economy, its complexity, and its likely impact in the world.

To have simply followed the norms, review every 4 years, was, we thought, going to be counterproductive and in fact might escalate the tensions instead of reducing them. We thought when we put our proposals together that organizing and systematizing a review would perhaps lead to some consternation, but in the end lead to less conflict so we would not resolve these issues by simply filing cases with the WTO.

So if this is enormously unpopular in China and it is a focal point for concerns about national humiliation, then we have to do a better job talking directly to people about why it is there. The last thing we are trying to do is humiliate. I think it is critical that that annual review work.

Ms. PEARSON. I would agree that it is absolutely critical for it to be constructive. There is no point to it if it is not constructive. I am hopeful, given what Mr. Freeman said this morning, that from both sides it can become more constructive than simply an exercise in frustration. So, I appreciate your comments very much.

Representative LEVIN. All right. Well, my time is up. I hope the three of you will be in considerable contact with us.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Levin.

I would like to turn a little bit to Professor Lau's observations and ask for a filling out of some circumstances.

When you note that China, as constituted, is doing a fair amount of assembling/process kind of work, are you talking about a circumstance that is more in the past and less in the future, or a circumstance that seems to be the established norm?

By that, I mean it would appear to me that China is developing on a rather rapid basis an infrastructure across the board in many fields of economic activity. This implies a greater prospect of internal Chinese development of a manufacturing base that is not as dependent upon imports as might have been the case in the past. Now, is that a fair observation, or how would you define your predictions of China for the future?

Mr. LAU. Mr. Chairman, I think your observation is correct, but I think it is going to be a long process. The Chinese per capita GDP today is a little bit less than $1,000 per year, which is a very low level. Even though growing very fast, it is still a country of great shortages. For example, each worker has very little capital to work with. The capital/labor ratio is very low and the vast number of people are basically unskilled.

So I see that this assembly and processing work would be ongoing for a long time. That does not mean that China would not try to move up the chain, but by and large moving up the chain does not really provide enough employment. So, I think the assembly and processing work would actually be ongoing for quite a while.

If you look at what happened to Taiwan, China is now doing everything that Taiwan was doing 25 years ago, assembling things. Then Taiwan has moved up. Someone just told me, on personal computers and hand-held devices today, that the design work is actually being done in Taiwan. It used to be done in Silicon Valley in California, and now it has all moved to Taiwan. So, Taiwan has sort of moved up the chain and just given the assembly work across the strait.

I think that is pretty much what really is happening. Korea is doing the same thing. Japan. So the Chinese are getting all the assembly work, but it does not pay very much. The value added proportion is very low.

Chairman LEACH. Let me ask all of you, in a general macroeconomic sense, observers of the world economy that includes Asia, that is not exclusive to Asia, have noted that capacity to produce almost everything is in excess today.

If you take the human component, if you take the Asia side of the Pacific Rim, there are approximately 3 billion people, of which two-thirds are work age. If you take America, we have 110, 120 million in the workforce.

There are very few things that increasingly, with modern communications, apply not only to all of the electronics, but with more sophisticated shipping of cargo, and for that matter more sophisticated rail shipping in the United States, that it is going to be harder and harder to keep manufacturing here in America given these trends.

So one of the great questions is how you bring equity to trade. Then it is compounded by this notion that modern communications imply productivity improvements that are rather substantial. So, last year, the stunning statistic in America that we had a 5 percent productivity increase and a decrease in employment, that is a fairly stunning thought.

In a way, it applies to us, but it also could apply to China. That is, a 10 percent GDP pick-up may not mean a 10 percent employment pick-up. When one thinks of massive unemployment in China or underemployment in China, that is a worrisome thing for their society from their perspective, and also one that, from our perspective, makes us wonder how we keep our workforce intact.

Do any of you have recommendations on the right level of American judgment that should be applied to our situation and the right level of judgment that ought to be applied to theirs? How do we parse these demographic situations in such a way that all our societies benefit? Is that a conceivable thing to do?

Mr. Huang, do you have any thoughts?

Mr. HUANG. Let me get to this question maybe from a slightly different perspective. I want to emphasize that there are similarities between China and the rest of East Asia in terms of their increasing export capacity.

But there is a critical difference. That difference benefits the United States far more than the growth of Japan and other East Asian economies in the 1960s and 1970s. That is the role of foreign direct investment. Mr. Chairman, you are exactly right that technology is moving in such a way, the communication costs are coming down, air transport, shipping, all these things are becoming extremely cheap.

So, to the extent that some of these manufacturing operations are going to migrate out of the United States, then this country is faced with two choices. One is do you want to lay a claim on the assets abroad, such as in China or do you want to face the competition from the Chinese companies owned and operated by the Chinese themselves?

Now, foreign direct investment is enabling the United States to lay a claim on this incredible growth of industries in China. Motorola alone, in the 1990s, just one company, accounted for 50 percent of Chinese electronics exports to the United States. The shareholders of Motorola benefit from this. The affiliates of Motorola benefit from this, because many of these products come back to the United States to feed into the next chain of production, whereas, the United States was not able to do that vis-a-vis Japan, vis-a-vis Korea.

So, China's growth is not achieved at the expense of America at large. I recognize that there are manufacturing industries in the United States, that labor is suffering. But there are a lot of other people who benefit from this. The Wal-Mart example is a very good one. I shop at Wal-Mart, and as far as I can see there are a lot of Americans shopping at Wal-Mart.

They benefit tremendously from the production of goods in China in two ways, financially, because American citizens have a financial claim over these assets in China, and second, they benefit because they can buy these goods at very cheap prices.

Chairman LEACH. Dr. Lau.

Mr. LAU. Mr. Chairman, if I just might add, very briefly. One interesting thing is that the United States and China are actually complementary in terms of their industrial mix. China does not export anything that we export. We do not export anything that China exports. So, it is actually a good fit.

Representative LEVIN. How about steel?

Mr. LAU. I mean, China is now importing a lot of steel.

Representative LEVIN. They exported it in 1997.

Mr. LAU. That is right. There might be some exceptions, but by and large the economies are very complementary. We are good at high-tech, they are good at assembly.

I think that is why there is actually a much better basis for these two economies to work together than, for example, between the United States and Japan, where there is actually much more competition. So I think one should be able to fashion a win-win strategy.

Now, I accept that there are transition pains on both sides, because there will be job displacement on both sides. For example, General Motors establishing a shop in Shanghai is going to drive out some local Chinese automobile firms. Many of them have to go.

So it is really the adjustment costs that we need to think through, as to how we take care of the displaced workers, both in this country and in China.

I think that there should be enough gravy generated that we can actually fashion something that could work. I actually try to promote an idea. We know that textile factories in the Carolinas are doing terribly. I actually floated the idea that perhaps some large textile company in China should come and take a look, see if they could take over some of them, take over the workers, use the brand names, continue the brand names and sort of keep the companies going.

I think there are really ways of making this work so that it would actually be mutually beneficial. It does not have to be a trade war. It is much better to increase exports of both countries than to reduce exports of both countries to the other. Thank you.

Chairman LEACH. Ms. Pearson, do you want to add anything? Is there hope?

Ms. PEARSON. Well, I think that it is a difficult situation. It is fundamentally difficult. But what troubles me about so much of the debate that I hear now, particularly about the insertion of this currency manipulation argument, is that if you are concerned about the loss of American manufacturing jobs to pressure China to float its currency, it does not solve the problem.

The loss of American jobs or China's taking over of manufacturing is, as many have said but it does not seem to be heard in this debate, taking over jobs that have come to it from the rest of East and Southeast Asia. So, it is troubling to hear the argument that if China floats its currency it is going to save American manufacturing. I think that kind of broad-brush approach to the problem is difficult.

Again, I have not heard it too much from this body, but when I read the media and when I hear much of what is going on in the political discussion and the discussion among pundits in Washington now, that assumption frequently seems to be made.

Chairman LEACH. Let me just say, I do not think there is anyone that thinks that simply changing the currency saves the jobs. I do think that there is an equity issue that is not trivial. It comes back to economics.

Several of you are economists, whether you believe in fixed exchange rates or flexible exchange rates, and whether or not there are models of manipulation based on fixed rates that benefit some parts of a society and disadvantage other parts. That implies both within the two societies that are involved in this circumstance, or the multitude of societies that are involved. I think the case for moving the direction of flexible exchange rates is good for all parties.

I also think that it is a more stable system and that experiments with trying to keep things fixed, which implies stability, is actually a very unstable situation. I think that is mainstream American modern economic thinking. I do not think that is aberrational thinking.

Although there are cases in which you have economists who have argued that sometimes there is a case for a country to have a fixed exchange rate using the United States as a currency base. We experimented with that with Argentina; not only did it not do well in Argentina, it set a real cloud over America's economic relations with the rest of Latin America.

So I am not arguing for any precise number, but I do argue very strenuously for flexible exchange rate regimes as being helpful to all modern societies. I think you also have, from China's perspective, a circumstance where, if you have flexible exchange rates, it is like the WTO.

You enter into a fair trade regime and you protect your ability, if you have the ability, to do things better than someone else. If you do not have that ability, you are unprotected. So I think it is something that one should not be apologetic about arguing for. I think it is very much in the interest of world society.

Even though Sandy's brother notes that it is not a very compelling argument in countries like Japan or China about protecting

the public, I think it is a protection to public treasuries not to have fixed exchange rate regimes that get artificially propped up because the sum total of trade can overwhelm those public efforts, so it is a reasonable thing to assert and affirm.

Ms. PEARSON. In terms of where the economic system eventually will get in China, I think that is very reasonable. Indeed, it seems to me that Chinese banking officials and very high-level officials have argued for many years that the goal is to eventually float the currency. The real debate is over whether it should be done tomorrow, or by 2005, or 2010. That is probably where the disagreement comes on it from both the Chinese side and this side.

Chairman LEACH. Both the Chinese and what side?

Ms. PEARSON. That is where it comes from both sides, the Chinese side and the U.S. side.

Chairman LEACH. I want to be careful. I think that is where the debate comes from, the Chinese side. I do not think it is the position of the U.S. Government to assert 2010. I think that a general frame of reference is one for competition in exchange rates. So I do not think it is a both-sided thing.

Ms. PEARSON. I understand the U.S. Government is not giving a date of 2010. I am saying that the dispute is probably over the pace at which we get there.

Mr. HUANG. Also, I think it is sequencing. It is timing as well as sequencing. The real flow of the currency, at a time when Chinese financial institutions are struggling with 50 percent bad loans on their balance sheet, the state-owned sector is in a huge mess, do you liberalize the capital controls at this particular juncture?

So the timing is actually conditional upon the sequence of reforms that the government has to undertake. I do not think it is in the interest of the United States to engineer something that may lead to a higher probability of a financial crisis in China.

So pegging the currency actually serves two purposes. One, is to keep the Chinese currency cheap in order to increase China's competitiveness. But this is a function that is being performed now.

In 1997, the pegging of the Chinese currency served to prevent a massive depreciation of Chinese currency that would have destabilized Asia in a very dramatic fashion as Thailand, South Korea, and other Asian countries went into a financial crisis.

So I think there is a need to be cautious about when to do this and what kind of unanticipated effects can be associated with such a dramatic change in the currency pegging system.

Representative LEVIN. Let me just say, I guess we are winding up. I think we understand there are complexities, but they sometimes tie us into knots. I do not think that that is where we should be.

The same, if I might say so, is to Professor Lau's argument about transition. First of all, I think in some sectors China is moving to value added production and more rapidly than some thought. It is not that they are simply assembling things that come from elsewhere.

That was true some years ago, but I think it is increasingly changing. There is more talent there than we give credit for, more engineers there than we sometimes understand.

Second, I think people in this country are asking—and it is a legitimate question—transition to what? The fact that there is no answer here in terms of job loss, I think, illustrates the question of "transition to what" is an important issue that we need to consider.

We do not have time, but the textile and apparel industry is a good example. There is a fear not only in the United States, but in the Caribbean generally that China, once the quotas are lifted, will capture 75, 80 percent of the market, and not simply by assembling materials that come from elsewhere. So it may be a small part of the GDP of the United States, but it would be a pretty large part of the GDP of Caribbean nations.

But we will have another hearing, right?

Chairman LEACH. I want to have just one more question. The three of you are experts from where you reside on the subject of academics. I raise this because, having just been to the Far East, I am really struck by the sensitivity of the issue of visas and how we go about issuing them, and what could occur come next January when new rules go into effect.

I am a big believer that education is an export item, as well as a cultural circumstance. The United States has begun the process of restricting our own exports, which is a bizarre situation.

Now, we all recognize the new order in the world and the new challenges to the world, and we all recognize the difficulty in making exceptions in some parts of the world to the rules on visas.

But I am worried sick that the United States is going to (a) lose an export market, and (b) cause real kinds of dissent in parts of the world that we do not like to see dissent increase.

Now, from your perspectives at MIT, the University of Maryland, Stanford, are you sensing this sort of thing developing, or have I exaggerated that prospect?

Professor Lau.

Mr. LAU. This is a problem. We noticed that a lot of students are contacting us about not having enough time. We actually sometimes have to call or write our consulates, hoping to move and expedite the process.

But I think I would say, with sufficient notice, we can probably do it. I mean, we just have to move the dates up a little bit.

But I think what we could also do to make it easier is perhaps to somehow raise the visa fees and hire more people, because it increases through-put. There is really no reason why someone who is coming to either Stanford, MIT, Berkeley, whichever, they have honest-to-God admissions and they are good students, why we should not try to process them as quickly as we can, subject to our rules.

I think having more people would make it possible, because right now the big bottleneck is scheduling the interviews, I understand. Everybody has to be interviewed.

Chairman LEACH. In addition, they are going to be required to be fingerprinted, or other kind of biological identifier.

Mr. LAU. I think that is all right. I mean, I do not think people would object to fingerprinting, or retina scanning, or whatever. I think that actually is a process that I think every country is moving to, because I think that basically eliminates counterfeiters. So

I think people can understand that. But I think it delays the timing.

Chairman LEACH. That matters the most.

Mr. LAU. Yes.

Chairman LEACH. Where the good students at Stanford and Berkeley, and the great students at the University of Iowa. Is that what you are saying?

Mr. LAU. Right. Exactly.

Chairman LEACH. Ms. Pearson.

Ms. PEARSON. My concerns are actually very similar to yours. We do lose very good students who do a lot for us when they are here, and in important ways serve as ambassadors or modes of communication between the United States and China when they return home. I am concerned about it.

Chairman LEACH. Thank you.

Dr. Huang.

Mr. HUANG. I think this is an extremely important issue. There was a story in the New York Times about a Chinese doctor who was unable to come to a medical conference in the United States.

The reason I bring up this story, is that the date of the publication of that story is very significant. It appeared on September 10, 2001. The next day, out of 19 hijackers of these planes, I think half of them did not really need a visa to come to the United States.

So these kinds of restrictions are being placed on the Chinese, extremely talented people who come to study, who then may decide to stay as I have, but we are continuing to make contributions to both the United States and to China. Many of these people are not allowed to come. The educational programs are not just benefiting from this kind of exchange financially.

The United States gains a tremendous amount of benefit in terms of the values, in terms of knowledge that we impart to the younger generation of Chinese. I would urge the U.S. Government to keep that in mind when it designs its policies on this issue. Thank you.

Chairman LEACH. Well, thank you all very much. Thank you. Let me bring this hearing to an end and say we are particularly appreciative of the academic witnesses, particularly the two of you that have come from far distances. Ms. Pearson, we consider you a home town source of great value.

Thank you all very much.

[Whereupon, at 2:05 p.m. the hearing was concluded.]

A P P E N D I X

PREPARED STATEMENTS

PREPARED STATEMENT OF HENRY A. LEVINE

SEPTEMBER 24, 2003

Mr. Chairman and members of the Commission, thank you very much for inviting me to participate in this hearing.

The Department of Commerce is dedicated to making sure "China is playing by the rules" and we continue active efforts, in coordination with U.S. companies and other U.S. agencies, to that end. I recently returned from China with Assistant Secretary William Lash. We worked on preparations for Secretary Evans's October trip to China and met with senior officials to discuss China's WTO compliance record and other bilateral trade issues. We stressed the need for China to implement its WTO commitments fully and on time.

The stakes involved in seeing that China "plays by the rules" are large. China is our fourth largest trading partner. Bilateral merchandise trade reached $147.2 billion in 2002. Our imports from China have been growing rapidly. China overtook Japan to become our third largest source of imports last year, and surpassed Mexico in July to become our second largest source of imports. Because our imports from China are more than five times greater than our exports, China has become our largest deficit-trading partner. The bilateral trade deficit, which hit $103 billion in 2002, reached $65 billion in the first 7 months of this year.

While our deficit with China has continued to soar, it is also worth noting that since 2001, China has been by far our fastest growing export market among our top 10 trading partners. Although our exports to the world declined 7 percent in 2001, 5 percent last year, and rose less than 3 percent in the first 7 months of this year, our exports to China surged 19 percent in 2001, 15 percent last year and more than 22 percent in January–July. Along with the United States, China now accounts for most of the current growth in the world economy.

As you know, the Administration has placed much emphasis on responding to the concerns of the U.S. manufacturing sector. In March 2003, Secretary Evans directed the Commerce Department to lead a comprehensive review of the issues influencing long-term competitiveness of U.S. manufacturing, and to outline a strategy for ensuring that government is doing all it can to create the conditions for manufacturers to thrive. This review will culminate in a report to be released later this fall. In developing this report, Commerce Department officials held roundtable discussions in more than 20 cities across the country—from Manchester, NH to Columbus, OH to Detroit to Los Angeles—meeting with manufacturers in the aerospace sector, autos, semiconductors, pharmaceuticals, among others.

In response to the concerns we have heard, Secretary Evans has already announced several new initiatives, including the creation of an Assistant Secretary focused on the needs or manufactures supported by a new Office of Industry Analysis to focus on the needs of American manufacturers, the creation of a new Assistant Secretary for Trade Promotion to boost our exports, and the establishment of an Unfair Trade Practices Team to track, detect and confront unfair competition.

During the roundtable discussions, no country raised more attention as a source of concern than China. Our manufacturers complained about rampant piracy of intellectual property; forced transfer of technology from firms launching joint ventures in China; trade barriers; and capital markets that are largely insulated from free-market pressures. We have also heard rising concerns about the pace and direction of China's implementation of its WTO commitments in areas such as transparency, IPR protection, trading rights and distribution services, agriculture, and financial services.

Americans are willing to compete, on even terms, with any country in the world but we will not stand for unfair competition. We will not look the other way or wait idly. As the Secretary stated in a recent speech to the Detroit Economic Club, "American manufacturers can compete against any country's white collars and blue collars, but we will not submit to competing against another country's choke collars."

To ensure that China honors its commitments and that U.S. companies benefit from these opportunities, we have adopted an aggressive and multi-pronged approach. We are going to target unfair trade practices wherever they occur. We are exploring the use of new tools to expand our trade promotion activities related to China. We are expanding our efforts to engage Chinese officials to help make sure

they "get the rules right" as they continue their massive task of restructuring their economic system.

In the area of intellectual property rights (IPR) protection, despite China's commitments to cracking down on rampant piracy, fake CDs, DVDs and pharmaceuticals continue to flood the market, costing us estimated $20–25 billion annually. In fact, the Business Software Alliance estimates that software piracy rates in China exceed 90 percent. In response, we continue to insist that the Chinese government take the steps necessary to bring these problems under control. We have raised specific IPR concerns at our meetings with senior Chinese government officials. Through the annual Special 301 process, working with our colleagues in other agencies, we continue to closely monitor China's IPR conditions. To make sure that China has the tools to implement its commitments we have organized a series of seminars with Chinese officials conveying U.S. views on how best to increase criminal enforcement of IPR violators and stop cross-border trade in pirated products. We think China can and should do better in these areas. We will continue to press for this goal.

In our manufacturing roundtables many companies have expressed concern over the exchange rate of the Chinese Yuan. This administration believes that currency values should be set by free-market forces. Secretary Snow delivered exactly that message to the Chinese government 3 weeks ago.

While continuing our focus on China's WTO implementation and other trade practices, we will continue to enhance the ability of U.S. businesses, especially small and medium-sized businesses, to compete in China. We are launching "Doing Business in China" seminars in cities across the country, which address small business concerns pertaining to the Chinese market. We are enhancing our efforts to insure that U.S.-developed technical standards are accepted in China just as they are accepted elsewhere internationally. We are exploring ways to develop more trade leads in China and to provide even more targeted information on China opportunities for companies in the United States.

Combined with these domestic efforts, we regularly engage Chinese government officials to ensure trade agreement compliance and market access for our products and services. Secretary Evans will visit China in October to advance U.S. interests and ensure U.S. companies face a level playing field in our economic relations with China. We will have another opportunity to raise outstanding issues during the 15th U.S.-China Joint Commission on Commerce and Trade (JCCT). Secretary Evans has issued an invitation to host China's Minister of Commerce Lu in Washington for the JCCT by the end of this year. We are still awaiting an official response.

Thank you for devoting this hearing to these important issues, and I welcome your questions.

PREPARED STATEMENT OF CHARLES W. FREEMAN III

SEPTEMBER 24, 2003

Thank you for inviting me to appear before you today to discuss the Administration's perspectives on the United States' trade relationship with the People's Republic of China and, in particular, the topic of China's WTO implementation.

CHINA'S IMPLEMENTATION OF ITS WTO COMMITMENTS

China acceded to the WTO on December 11, 2001, after 15 years of negotiation with the United States and other members of the WTO and its antecedent, the General Agreement on Tariffs and Trade. China's accession was a watershed event for both China and the United States. By committing to implement the WTO's market access, national treatment and transparency standards; protect intellectual property rights; and limit the use of trade-distorting domestic subsidies, China promised to deepen and consolidate the market-oriented economic reforms first initiated in the years following the death of Mao Zedong. For the United States, China's WTO accession not only promised unprecedented market access to one of the world's most intriguing, and fastest growing, economies; it also provided a forum through which the United States and China could mediate and resolve trade disputes without the use of unilateral measures. At its heart, China's WTO accession represents a commitment by China to play by the established rules of international trade both at the border and internally, and thus was a fundamental step toward establishing the primacy of the rule of law in China.

China has now been a WTO member for more than 21 months. In that time China has completed much of the nuts-and-bolts work of WTO implementation: amending and promulgating thousands of laws and regulations to effect its WTO commit-

ments, establishing new transparency procedures in many national and sub-national agencies, and reducing tariffs to their committed levels. This work has taken place against a challenging political and social backdrop: since December 2001 China underwent a major leadership change; passed through a harrowing national SARS epidemic; faced unprecedented protests by some 600,000 Hong Kong citizens; and generally has confronted the host of dislocations inherent in its transition from a planned to a more market-oriented economy.

Whether or not China's domestic difficulties have had an impact on its ability to implement its WTO commitments in both letter and spirit, the Administration has noted a variety of shortcomings in WTO implementation over the course of the past 21 months. As highlighted in our 2002 Report to Congress on China's WTO Compliance, covering China's first year of WTO membership, China's WTO implementation was most problematic in the areas of agriculture, services, enforcement of intellectual property rights and transparency. Although we have seen progress in some of these areas, they still remain areas of serious concern. At the same time, other areas of concern have begun to emerge. For example, China's use of certain tax policies to favor domestic production or provide incentives to increase exports has developed into a significant source of concern. In some sectors that the Administration has engaged with China and resolved WTO trade-related concerns, new problems have emerged in place of those resolved through engagement.

In our experience, China's compliance problems are occasionally generated by a lack of coordination among relevant ministries in the Chinese government. Another source of compliance problems has been a lack of effective or uniform application of China's WTO commitments at local and provincial levels. China is taking steps to address both of these concerns, through more effective inter-ministerial mechanisms at the national level, and through a more concerted effort to reinforce the importance of WTO-consistency with sub-national authorities. In other cases, however, compliance problems involve entrenched domestic Chinese interests that may be seeking to minimize their exposure to foreign competition. These problems are difficult to deal with, and even after the Administration has engaged with China and resolved our concerns, new problems have often emerged in place of those resolved through engagement.

The central lesson the Administration has learned with respect to China's WTO implementation is that the years of tough negotiations that led up to China's WTO accession were no accident. We will need to match the painstaking efforts and persistence of those negotiators in order to ensure that China implements its commitments fully. While providing an exhaustive inventory of bilateral trade concerns is beyond the scope of this statement, I would propose to highlight a number of central concerns and the ongoing efforts of the Administration in pursuing their resolution.

AGRICULTURE

China's potential as a market for U.S. exports of bulk agricultural commodities was a key factor in U.S. support for China's WTO accession and grant of Permanent Normal Trade Relations (PNTR) status to China. While bumper harvests of some crops in China in 2002 may have limited the commercial potential of some U.S. exports, China's attempts to restrict certain agricultural imports has been an ongoing theme of the first 21 months since China's WTO accession. The use of—or even the threat to use—questionable GMO standards and sanitary and phytosanitary (SPS) measures to restrict imports of some products for alleged health and safety concerns has frustrated efforts of U.S. agriculture traders, most notably in the case of soybeans. In the case of those bulk agricultural commodities subject to negotiated tariff-rate quotas (TRQs) in China, the setting of sub-quotas, use of Catch–22 import licensing procedures, allocation of TRQs in commercially unviable quantities and a lack of transparency in TRQ allocation and management have combined to disturb what should be a ready market for U.S. exporters, particularly in the case of cotton.

After the efforts of Ambassador Zoellick, Agriculture Secretary Veneman and others in the Administration, the commercial impact of these potential barriers was contained. U.S. exports of soybeans topped $1.2 billion—a record—and cotton sales were already 8–10 times greater than in any previous calendar year by July, 2003. Nevertheless, systemic problems with both GMO and SPS regulation continue to hang like a cloud over the marketplace, and a negotiated settlement to our concerns with China's TRQ system has yet to be fully implemented. These and other emerging concerns, such as China's apparent use of supports to promote agricultural exports, will require continued vigilance and engagement by the Administration in order to prevent a disruption in this important trade.

INTELLECTUAL PROPERTY RIGHTS

In the year leading up to WTO accession, China did make significant improvements to its framework of laws and regulations protecting intellectual property rights (IPR). However, the lack of effective IPR enforcement in China is a major obstacle toward a meaningful system of IPR protection. IPR problems run the gamut, from rampant piracy of film and other entertainment products, to sophisticated software and semiconductor products, to counterfeiting of consumer goods, electrical equipment, automotive parts and pharmaceuticals. IPR infringements not only have an economic toll; but also present a direct challenge to China's ability to regulate those products that have health and safety implications for China's population and international purchasers of such products. While a domestic Chinese business constituency is increasingly active in promoting IPR protection for self-interested reasons, the problem is immensely widespread. If significant improvements are to be achieved on this front, China will have to devote considerable resources and political will to this problem, and there will continue to be a need for sustained efforts from the United States and other WTO members.

The United States has had an ongoing dialog with China on IPR matters for a number of years, including through an annual series of bilateral meetings chaired by USTR and its Chinese counterpart, the Ministry of Commerce, the next series of which is scheduled for November this year. Ambassador Zoellick, Secretary Evans, and, most recently, Secretary of Treasury Snow have used every occasion to press China on the importance of a more effective regime for IPR enforcement. In the view of the Administration, the key to achieving this end will be for China to increase deterrent-level criminal penalties for IPR violators, demonstrate a willingness to increase prosecution and punishment of IPR offenders, to lower thresholds for criminal prosecution, to increase resources and devote more training for enforcement in all parts of China, and to establish more effective communication procedures between relevant officials of China's courts and investigative units, the Supreme People's Procuratorate and China's lawmaking bodies.

SERVICES

Meanwhile, concerns arose in many services sectors, principally due to transparency problems and China's use of prudential requirements that exceed international norms. The United States and China have had reasonably cooperative talks to resolve these concerns in many of the affected sectors, but progress has been slow and not without frustrations. In some cases, such as express courier services, much progress was made toward resolving regulatory concerns in 2002, but problematic regulations remain under consideration, even if they have yet to be implemented. In other cases, such as implementation of China's commitments on branching by insurance companies, the United States and China remain at odds despite a longstanding cordial and otherwise productive dialog with Chinese regulators.

VALUE-ADDED TAX POLICIES

China has increasingly used value-added tax (VAT) policies to encourage domestic industrial or agricultural production in a number of sectors. In the case of semiconductors, China's policy of providing rebates of VAT to domestic semiconductor producers disadvantages U.S. exports and raises significant WTO compliance concerns. In the case of fertilizer, China exempts from the VAT fertilizers that compete directly with the principal U.S. fertilizer export, a practice that is difficult to justify by WTO rules. In addition, we also have received reports that China has been rebating the VAT paid on domestically produced agricultural goods, including corn, and even that China is rebating the VAT in such a way as to subsidize exports—a particularly serious charge, given China's WTO commitment to eliminate export subsidies. The Administration has engaged China on all these practices, and will continue to pursue the elimination of discriminatory or trade-distorting VAT policies through appropriate channels in Beijing, Washington and Geneva.

CHINA'S WTO TRANSITIONAL REVIEW MECHANISM

China was admitted to the WTO on somewhat unique terms. Rather than completing the process of implementing its WTO commitments as a pre-condition of WTO membership, China was admitted to the WTO by committing to implement them. In large part to monitor China's transition toward full implementation, the WTO conducts an annual review of China's implementation progress: the Transitional Review Mechanism (TRM). This review, which will take place in 8 of the next 9 years in 16 subsidiary bodies as a lead-up to the year-end meeting of the WTO's General Council, is an opportunity for other WTO members to engage China on the

extent to which it has complied with its commitments and to clarify China's trade practices. The first year of the TRM was marked by some misunderstanding between China and other WTO members as to expectations of China at the TRM, but communication clearly improved as the process unfolded. The Administration expects a smoother and more useful TRM in year two and beyond.

IMPORTS

The trade imbalance between the United States and China topped $103 billion in 2002, and threatens to climb higher in 2003. I should point out that this is in part a result of the expansion of our overall trade relationship: While imports from China out pace those from all other WTO members, China is also our fastest growing export market. In 2002 our exports to China were over $22 billion, and, with exports through July 2003 up 22.7 percent compared with the equivalent period in 2002, China has become our 6th largest export market. Nevertheless, the rapid expansion of trade between our two countries has inevitably lead in some cases to competition between domestically produced goods and imports in both our markets. To the extent China unfairly protects its domestic producers to the detriment of competition from United States, the Administration continues to be prepared to assert U.S. interests. To the extent imports from China disrupt U.S. markets, the Administration is fully prepared to assert the rights of the United States under China's WTO accession agreement.

As part of China's WTO accession package, China agreed to two separate China-specific safeguard mechanisms to allow WTO members to cope with market disruptions caused by increasing economic integration with China, particularly during the period when China is still phasing in its WTO commitments. One such mechanism, the product-specific safeguard, was codified as Section 421 of the Trade Act of 1974, as amended, and is available until December 11, 2013. Since the implementation of Section 421, three petitions have been brought requesting import relief. In one case, the International Trade Commission found that our domestic producers' market had not been disrupted by imports from China. In two other cases, while the ITC found market disruption, the President determined that the adverse impact on the U.S. economy was clearly greater than the benefits from providing import relief. While to date no import relief has been granted under Section 421, the President, in his most recent determination, reiterated his commitment to using the safeguard when the circumstances of a particular case warrant.

The second safeguard agreed to by China as part of its WTO accession package is specific to textiles, and allows WTO members the opportunity to invoke limited import relief—specifically a 7.5 percent cap on growth in imports of a given textile category for up to 1 year (6 percent for wool products)—until December 31, 2008. The Administration is currently reviewing three requests under this safeguard mechanism, and initial determinations will be forthcoming in mid-November of this year.

U.S.-CHINA DIALOGUE ON ECONOMIC MATTERS

The Administration maintains three formal dialogs with Chinese ministries. The Commerce Department chairs meetings of the Joint Commission on Commerce and Trade; the Treasury conducts meetings of the Joint Economic Commission with the Chinese Ministry of Finance; and USTR chairs an interagency Trade Dialogue with counterparts from the Ministry of Commerce and relevant other Chinese agencies. Like many of the informal contacts, these formal occasions are opportunities not merely to discuss bilateral and multilateral trade and economic matters, but are themselves action-forcing events at which significant progress can be achieved. They also act as an early warning system on trade problems—providing an opportunity to resolve issues before they become broader bilateral irritants.

In addition to these formal processes, the Administration meets frequently on both the Cabinet and sub-cabinet level with senior Chinese officials, and uses such meetings to press the importance of economic issues with Chinese counterparts. In the case of USTR, Ambassador Zoellick meets or speaks via telephone with PRC Minister of Commerce Lu Fuyuan on a regular basis, has been to China twice since December 11, 2001, and plans to travel to China again for bilateral discussions next month. Ambassador Josette Sheeran Shiner recently confirmed as Deputy USTR, plans to continue an active dialog with her counterparts, and other USTR officials meet regularly with Chinese officials on bilateral trade concerns, whether in Washington, Beijing, or at the WTO. These exchanges are critical opportunities to advance bilateral and multilateral trade and economic matters, and have proven effective in making progress on key U.S. concerns.

CONCLUSION

Mr. Chairman and members of the Commission, thank you for providing me with the opportunity to testify. I look forward to your questions.

PREPARED STATEMENT OF GARY C. MARTIN

SEPTEMBER 24, 2003

Thank you for the honor and opportunity to address the Congressional-Executive Commission on China.

The North American Export Grain Association (NAEGA), established in 1912, is comprised of private and publicly owned companies and farmer-owned cooperatives involved in and providing services to the bulk grain and oilseed exporting industry. NAEGA member companies ship practically all of the bulk grains and oilseeds exported each year from the United States. The Association's mission is to promote and sustain the development of commercial export of grain and oilseed trade from the United States. NAEGA acts to accomplish this mission from its office in Washington DC, and in markets throughout the world. NAEGA has a joint operating and service agreement with the National Grain and Feed Association (NGFA), whose 1,000 member companies consist of all sectors of the U.S. grain, feed processing and exporting business. NGFA member companies operate approximately 5,000 facilities that handle more than two-thirds of all U.S. grains and oilseeds. NGFA and NAEGA coordinate policy and government representation on trade related issues that affect economic prospects of the industry. This enables the organizations to speak in a unified voice to government and to the industry's domestic and international customers.

Our trade relationship with the People's Republic of China is of great importance to the economic success of U.S. agriculture. Compliance with the World Trade Organization (WTO) rules is a foundation of successful economies around the world as well as critical element in a successful trade relationship with China. The North American Export Grain Association has a long history of facilitating the export of U.S. wheat, corn and soybeans to China. We are very much engaged in resolution of concerns related to several questions to be addressed in today's hearing. In particular, I would like to focus on three questions: Which Chinese government policies have made Chinese exports competitive? Which remaining non-tariff barriers hinder market access for U.S. imports into China? and, what type of U.S. Government policy changes could help in changing conditions in China?

By most measures, China's efforts to meet it's WTO commitments to reduce both tariff and non-tariff barriers in the agricultural sector have been met with mixed results. There has been welcome progress in some key areas such as tariff reductions. Unfortunately, many issues that amount to non-tariff barriers continue to limit progress under China's WTO commitments and exports to the Chinese marketplace. However, from the perspective of U.S. agriculture and the grain trade, the impact of China trade is difficult to overstate. Likewise the implementation of China's WTO commitments continues to have a profound impact.

To put some perspective on the questions under consideration by the Committee, we should acknowledge the recent growth in agricultural exports to China. On a July through June basis, we have seen total value of U.S. agricultural exports to China rise from less than $500 million in 1999 to almost $2.25 billion in 2003. Since China was accepted into the WTO (December 2002), it is safe to say that U.S. agriculture exports to China are on a pace to double in value.

When China imports the impact can be quite dramatic. Our soybean sales to China this year may exceed $2 billion. U.S. soybean exports to China represent not only a very large percentage of overall U.S. soybean exports but also big piece of our overall agricultural export value and very large, market dominating share of world trade in soybeans.

When China stops imports or fails to meet expectations, the result is a large negative impact on our agricultural markets. A short 20–30 day interruption in soybean trading (due to uncertainty over biotechnology policy) last year may have resulted in up to $100 million in lost U.S. sales. Expectations of large export markets for U.S. corn and wheat simply have not been met. While import demand for these crops is largely dependent on domestic supply, we think it is clear that WTO non-compliant policies of the Chinese government have stimulated production, reduced access and, in the case of corn, subsidized exports. For wheat, calendar year to date exports total over 1 million tons—up 104 percent from 2002. Chinese wheat imports have fallen this year by 60 percent to about 200,000 tons. Chinese corn exports have recently overtaken several long term U.S. corn export markets. This year China has

exported 50 percent more corn than it did in the same period last year—a calendar year to date total of over 9 million tons. Our expectations were for Chinese membership in the WTO to result in significant imports from the United States of both corn and wheat.

As China continues to transition its economy and agricultural policies, we expect China will continue progress toward a policy more accommodating to international trade. I believe China recognizes the need to further open agricultural markets to provide for enhanced food security and economic well being. The difficulty is in the transition from a centrally planned and managed economy to an economy that benefits from allowing market forces to prevail. For agriculture, as we too have experienced, this transition can be especially difficult.

In response to these three questions: Which Chinese government policies have made Chinese exports competitive? Which remaining non-tariff barriers hinder market access for U.S. imports into China? and what type of U.S. Government policy changes could help in changing conditions in China?—There are several key issues related to trade in agricultural products that need to be addressed:

- Uncertainty regarding biotech regulations and the issuance of permanent safety certificates for biotech products. Much progress has been made in this regard. Our industry is especially appreciative of the effective and timely response of President Bush and his Administration in moving this complex and difficult issue very close to resolution.
- Labeling and information requirements on meat and poultry products that increase export costs without enhancing food safety.
- Chinese adherence to the Agreement on the Application of Sanitary and Phytosanitary Measures (the SPS Agreement). Particular concerns regarding the failure to utilize the International Plant Protection Convention and "zero tolerance" pathogen standards that are neither science-based or practical, as well as undue quantitative restrictions on meat and poultry imports.
- Administrative interference with import trade by China's quarantine authorities and Ministry of Commerce, including requiring import permits before signing purchase contracts and making shipment. Most administrative measures lack transparency and appear to be used to institute short term quotas established to address political concerns.
- Significant export subsidies for agricultural products, particularly corn.
- A range of problems with the implementation of China's promised tariff-rate quota (TRQ) system, including a lack of transparency, delay in the announcement of quotas, granting of insignificant and uneconomic quotas, imposition of restrictions that are not required of domestic producers or merchants, and inclusion of quotas for mandatory re-export.

While China has eliminated or reduced some tariff barriers, the benefits from these actions can be quickly offset by continued non-tariff barriers that restrict trade into China, create significant marketplace uncertainty and discourage further foreign investment. The agricultural TRQ issue has the potential to be the first case against China under the WTO dispute resolution system. U.S. industry has consistently called for science-based, permanent rules for genetically modified organism (GMO) imports, a transparent TRQ system, and an end to agricultural export subsidies.

The progress made by the governments of China and the United States through collaborative work to reduce these unjustified barriers to agricultural imports has been significant and is certainly in the best interest of both countries and the modernization of Chinese food production.

We need to aggressively focus the attention and improve China's compliance with the WTO in three areas: (1) the regulatory practices of Chinese State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ); (2) the complete and final elimination of agricultural export subsidies; and (3) the implementation of agricultural TRQ systems.

AQSIQ REGULATORY PRACTICES

U.S. soybean, cotton and meat traders continue to experience significant restrictions on exports of products to China stemming from AQSIQ's posture on the issuance of Import of Animal and Plant Quarantine permits and its inspection procedures. Chinese quarantine regulations require importers to obtain import permits before entering into purchase contracts and effecting shipments. With import permits valid for only 90 days or less, buyers are locked into a very narrow period to purchase, transport and discharge their cargoes before expiration of the permit.

While the technical requirement imposed on importers is to obtain an import permit in advance of contracting for commodity shipments, the current AQSIQ requirement

is essentially unworkable, as importers buy products when prices are low—sometimes months ahead of actual shipment. Contracting parties cannot wait to obtain an import permit first, before making a contract for shipment of commodities.

Although China removed soybean import quota control in 1999, the Chinese government now appears to control import volume through WTO-inconsistent methods such as the use of quarantine import permits.

In the recent past, AQSIQ has slowed the issuance of permits, which has resulted in significant commercial uncertainty and, in some cases, has placed U.S. foreign investment in the Chinese agricultural sector at risk. Because of the commercial necessity to contract for commodity shipments when prices are low, combined with the inherent delays in having import permits issued, many cargoes of soybeans end up arriving in Chinese ports without import permits. This has created delays in vessel discharge and resulted in demurrage bills for Chinese buyers.

AQSIQ has committed to notify importers about the result of their permit application within 30 days of receipt. However, some importers are waiting well beyond 30 days without obtaining any feedback from AQSIQ, as provincial CIQ offices that act as intake centers for import permit applications appear to be asked to delay submitting these applications to AQSIQ in Beijing. This effectively extends the 30-day notice period AQSIQ has to respond to the party requesting an import permit.

Most recently, AQSIQ has suggested to foreign diplomats that it will take action to restrict specific firms from exporting or importing soybeans based on allegations that the firms have failed to meet certain quarantine regulation and mandatory quality requirements. The quality requirements and quarantine regulations are undocumented, non-transparent and do not comply with the requirement of the WTO SPS Agreement or the International Plant Protection Convention.

Recommendations:

- AQSIQ should restrict its activities to science-based, WTO and international convention compliant import quarantine procedures and should not impose delays, uncertainties, commercially discriminatory or commercially unrealistic requirements that inhibit free trade.
- AQSIQ should approach the approval of import permit requests in a timely and commercially realistic manner.
- AQSIQ should ensure that all formalities are transparent, with clear timelines openly promulgated.

AGRICULTURAL EXPORT SUBSIDIES

U.S. feed grain producers and exporters have serious concerns about China's failure to live up to the commitment to eliminate export subsidies for corn.

We are convinced China is using export subsidies to ship major volumes of corn into markets such as South Korea, Malaysia, Indonesia and most recently Japan. After a record-setting year in 2002, exporting more than 11.6 million tons of corn, China is currently 100 percent above that year's pace in exporting 6.7 million metric tons in the first 6 months of 2003 (1.8 million metric tons in June alone). Those exports have come mostly at the expense of the U.S. corn industry. If China's use of export subsidies for corn is not addressed now, we will continue to see significant erosion of U.S. markets throughout Asia.

Prior to its WTO entry, China subsidized corn exports at $40–$45 per ton. However, throughout much of 2002 and 2003, the price for Chinese corn exports has remained at pre-accession levels. Given China's ocean freight and internal corn costs, it is inexplicable how corn could be exported at those prices without further government subsidization, even after accounting for measures outlined by the Chinese government to reduce corn export prices. By calculating the size of the gap between domestic and export prices, the findings refute explanations given by Chinese officials as to how China was able to reduce corn export prices after WTO accession by means allowable under WTO rules, i.e., VAT rebate and transportation tax waivers.

Recently, world prices have increased while China's domestic corn prices have decreased, reducing the need for export subsidies. However, we still question how China is exporting at levels of $15 to $25 per ton below domestic prices. We are also concerned that the VAT is not being collected on domestic corn, or is being assessed at a much lower rate than the officially declared 13 percent. Furthermore, with China's grain stocks currently at a very high level, there will be additional pressure for China to continue to aggressively subsidize corn exports throughout next year if allowed to do so. China has exported more than 18 million metric tons of corn at price levels significantly below domestic prices during the past year. Although China has announced measures to lower the corn price for export within WTO disciplines, it is clear that corn exports continue to be subsidized by the government.

Although the subsidy gap between China's domestic and export prices for corn has narrowed in 2003, it still accounts for a substantial competitive advantage for China as its exports remain at record high levels. Based on data provided by the U.S. Grains Council, Chinese exports to South Korea in June were priced at $106 FOB China (Dalian). Mid-June domestic corn prices at Dalian were 1060 RMB/mt or $128/mt. On a direct comparison basis, the gap between domestic and export prices would then stand at $22/mt for June. Using a 6-month lag from the time contracts were signed and shipments exported—so that the June export price is compared to December 2002 domestic price (1030 RMB, or $124.50)—the gap amounts to about $18.50 (about 15 percent of the domestic FOB Dalian price).

While export prices for the July September period may be slightly higher than June's $106/mt, they most likely will not be more than $110/mt (current domestic Dalian prices are unchanged at $128/mt). That implies a significant gap continuing in the foreseeable future. If China continues to apply these levels of subsidies to corn exports the remainder of this year, U.S. exports will be significantly impaired in this current marketing year.

Recommendations:

- China should formally and fully account for the discrepancy in domestic and export corn prices.
- China should immediately meet its WTO commitment and proceed to eliminate the officially supported mechanisms that permit exports at lower than domestic prices.

AGRICULTURAL TARIFF RATE QUOTAS

China has not made sufficient progress[1] in implementing tariff rate quotas (TRQs) for bulk agricultural commodities such as wheat, corn, cotton and vegetable oil in a manner that opens the market to trade as anticipated under China's WTO accession agreement. Regulations designed to establish TRQ systems were late in being released, lack sufficient transparency and introduce unreasonable licensing procedures for importers. In some cases, China has contravened its accession agreement by allowing TRQs reserved for "non-state trading companies" to be issued to state-owned enterprises.

The TRQs for corn and wheat in many cases were distributed in such small quantities as to render them uneconomic to fulfill. When TRQs were issued, it has been very difficult, if not impossible, to ascertain which companies were granted quotas. This is in violation of the WTO agreement.

Of greatest concern is that the State Development and Reform Commission (SDRC) requires a significant portion of each TRQ be used only for processing and mandatory re-export of finished products. This restriction is most important for cotton, where well over one half of the TRQ is restricted to re-exports and represents a violation of China's accession agreement.

Recommendations:

- China should honor its TRQ obligations and not engage in such practices as: delaying announcements; granting insignificant, uneconomic quotas; applying restrictions that are not required of domestic producers or merchants; or designing non-tariff trade barriers that circumvent TRQ obligations.
- China should ensure that there is greater transparency in the TRQ process, including the requirement to publish a list of importers that have been granted TRQ allocations.
- China should eliminate the quota for mandatory re-export provisions.

In summary, much has been accomplished with regard to Chinese accession to the WTO and the commitments related to agricultural trade. However Chinese commitments and U.S. expectations are for additional and more timely progress. The United States and Chinese government have demonstrated an ability to resolve some outstanding issues. Given the importance of several unresolved concerns to both China, the U.S. and global markets, renewed commitment and additional effort by the United States, China, and the WTO are warranted.

Thank You

[1] It should be noted that China's Ministry of Commerce and National Development and Reform Commission has recently published a draft regulation amending management of TRQs for imported agricultural products. The impact of the new regulation needs further review.

PREPARED STATEMENT OF BRAD SMITH

SEPTEMBER 24, 2003

OVERVIEW

Thank you, Mr. Chairman and Commission Members, for the opportunity to testify. If it is acceptable, I would like to have my written testimony, which expands on my oral comments, added to the record.

The U.S. insurance industry strongly supported permanent normal trade relations (PNTR) for China because the Chinese accession package was extremely broad and deep, and when fully implemented holds the promise of opening the vast Chinese insurance market to U.S. insurance and retirement security providers. We were aware from the outset that no agreement is self-implementing, and that the key to realizing successful profit from Chinese accession to the WTO is an efficient and transparent implementation process.

With the ongoing leadership and support of the U.S. Government trade negotiators and facilitators, ACLI and our property casualty counterparts at the American Insurance Association have established what we consider to be a positive implementation dialog with the Chinese Insurance Regulatory Commission (CIRC), which has already led to a much improved communications and transparency process for U.S. insurers in China.

Based on draft regulations just released by CIRC, we are cautiously optimistic that our primary concern to date (unjustifiably high capitalization requirements) has largely been addressed. As the next step, we have submitted a detailed list of additional questions to which we are seeking clarification from CIRC. We are optimistic that the United States Trade Representative (USTR) will be able to schedule a meeting to review this agenda by the end of the year.

BACKGROUND

China's formal membership in the World Trade Organization offers great promise and opportunity for life insurers. The ACLI and the broader U.S. insurance industry, especially our property casualty counterpart—the American Insurance Association, were strong supporters of Permanent Normal Trade Relations (PNTR) for China because the insurance liberalization commitments contained in China's schedule of specific commitments and "Working Party Report" were broad and deep, holding the promise of opening the Chinese market to U.S. insurance companies and pension providers. Through experience with bilateral insurance agreements in Japan and South Korea, we knew at the time of China's accession that no agreement is self-implementing, and that the most important part of the opening of the Chinese insurance market would be in the implementation phase.

With China now in the WTO, through the good offices of the U.S. Trade Representative, the U.S. Commerce, State and Treasury Departments, and through the communications of many interested Members of Congress, we (ACLI and AIA) have begun the process of establishing a dialog with the Chinese Insurance Regulatory Commission (CIRC) about the implementation of their liberalization commitments. Establishment of regular, straightforward two-way communication is, in our opinion, the best way to avoid possible misunderstandings, frustrations or disappointment about China's liberalization process.

The task before CIRC is substantial, as it is in everyone's interest that the Chinese insurance market not only be open but well run and prudentially sound. Our intent is therefore to make a positive contribution to this process, by providing CIRC and other Chinese decision makers our comments on their implementing regulations, and where appropriate, include technical research to help them in setting standards that meet the test of prudential justification.

Individual company experience with CIRC varies greatly. Some describe relations as perfect and others describe them as frustrating, but our member companies support this constructive engagement approach for the same reasons many companies have funded representative offices all over China, some going back for more than 10 years. The Chinese market is seen to have tremendous potential, and many U.S. companies, like our international competition, see entry into China as key to a global strategy. Recent industry press headlines such as "Chinese Insurance Premium Grew 33 percent For First 7 Months" and "China Will Be Second Largest Insurance Market by 2032, Says IBM," typify stories of the growth of the market since first being liberalized in 1992—we intend to be part of that.

With regard to China's implementation of their WTO insurance commitments, while the process is moving forward, the lack of clarity in the regulatory process

has slowed and confused the fulfillment of China's insurance liberalization obligations.

Since joining the WTO in December of 2001, Chinese insurance regulators have promulgated five sets of regulations with the stated intention of implementing China's WTO insurance commitments. The first set went into effect in early February of 2002 and provided a general framework for the regulatory structure but offered little specificity regarding the implementation of their liberalization commitments. Procedures for branching, capitalization and solvency regulation and other fundamental processes by which U.S. Insurers could procure a license and begin operations were not included. US insurers provided an analysis of these regulations for USTR, pointing out the vagaries of the regulation as well as several specific regulatory articles that could be inconsistent with China's WTO obligations. USTR then met with Chinese regulators to communicate these questions and concerns and were told additional regulations would be forthcoming.

Chinese regulators subsequently released a second set of regulations in late February 2002 to further clarify the licensing procedures. USTR again communicated directly with CIRC regarding questions and concerns, which still had not been clarified. CIRC informed USTR of further forthcoming regulations and stated that China would fully implement their WTO liberalization commitments.

Concurrent with this informal bilateral dialog, USTR had requested answers to a detailed set of the same questions at the Transitional Review Mechanism discussion in the WTO Committee of Trade in Financial Services. This engagement has been continued at each subsequent CTFS meeting, with the same questions being echoed by the Governments of Canada, the European Union, Australia, South Korea and Switzerland.

Based on both the formal requests in the CTFS and the informal bilateral dialog, in October of 2002, Ambassador John Huntsman requested a meeting with CIRC that would be open to a small number of U.S. and Chinese insurance industry representatives as well as USTR representatives. At the suggestion of USTR, it was decided to focus exclusively on the highest priority issue—capitalization levels required of an initial establishment of a foreign insurer, and subsequent capitalization required when additional branches would be opened.

Our concerns were that the regulations were unclear because of conflicting overlap from multiple regulations, and because the amounts called for were well outside of prudentially justifiable international norms, thus creating a barrier to entry for many U.S. insurers. Our objective for the meeting was to seek clarification of the specific requirements, and to provide information on international benchmarks for prudentially justifiable capitalization levels. Thanks again to USTR, the U.S. Embassy in Beijing and the U.S. Commerce Department, on December 13, 2002 we participated in a meeting in Beijing with CIRC, Chinese industry representatives and a U.S. Government and industry delegation headed by Deputy Assistant USTR, Charles Freeman.

Our presentation, attached for entry into the record, was entitled "A Recommendation for Revisions to the Capitalization Requirement Rules for Life Insurance Companies Operating in China," highlighted just how far outside international norms China's capitalization levels were, and presented a model that our consultant, Watson Wyatt Insurance Consulting Limited, felt might be more appropriate for the Chinese life insurance market. CIRC listened, agreed that our worst-case projection of the capitalization requirements was currently correct, stated that there were plans to revise the relevant regulations, and agreed to consider our views.

Meanwhile, we discussed our capitalization concerns with other service industry groups in the U.S., Canada, Europe and Japan, fellow members of the "Financial Leaders Group" and found that our capitalization concerns were not unique. Service sectors such as banking, securities, auto finance and express delivery are facing similar problems. Thus, in February of 2003, the Financial Leaders Group delivered a letter to Chinese officials commenting on the prudentially unjustifiably high capitalization levels in many services sectors, including insurance, and the issue was again highlighted at the CTFS meetings in Geneva by the Quad Governments. CIRC subsequently stated that additional regulations to fulfill China's WTO liberalization commitments would be forthcoming.

It should be noted that neither of the first two insurance regulations were publicly released in draft for public comment. The U.S. industry provided comments anyway: No formal response was received.

On July 31, 2003 a third set of regulations ("The Draft Trial Implementing Rules on the Regulations of the PRC on the Administration of Foreign-Invested Insurance Companies") were placed on the CIRC web site with a request for public comment by August 15. To our surprise, on August 18, 2003, another set of regulations ("Draft Administrative Regulations on Insurance Companies of the People's Republic

of China") was also posted to the CIRC web site requesting public comment by September 16. In both instances, we translated the draft regulations and circulated them widely within the U.S. insurance industry.

In both instances we submitted formal written responses to CIRC within the requested timeframe. We commended them for their public outreach, and stated that their openness supports our firm belief that the most important factor contributing toward the successful development of the Chinese insurance sector will be the institutionalization of a regular and robust public dialog. We expressed our hope that this initiative can be expanded through increased communication and cooperation with interested international companies and industry associations, and committed ourselves to provide professional and timely responses to CIRC on an ongoing basis. We also stated that a dialog on these drafts and/or any revised drafts that CIRC circulates for additional comment would be an excellent basis for continuing the dialog we began last December in Beijing.

The major notable development in these recent drafts is a significant lowering of the required capital for initial establishment and full national operations, which, if implemented, bring the capitalization requirements closer to the acceptable range of international comparables for some lines of business and business models. This is a major step forward for CIRC, which we feel supports the benefits of continued dialog. We plan to extend this dialog to now include our other priority areas of concern.

Continuation of this dialog must be two-way. Many of our concerns involve confirmation of our understanding of the meaning of vague or conflicting regulations. So that this dialog is as clear as possible, we hope to receive written responses to our inquiries from CIRC. This has also been requested by USTR. We look forward to a meeting in Beijing to focus on this agenda by the end of the year, and greatly appreciate USTR's efforts to schedule it.

Top priorities we would like to have included in the dialog agenda are (by category of type of issue):

FUNDAMENTAL ASSUMPTIONS

We seek confirmation of the following fundamental assumptions, which are key to our understanding of the prudential intentions of the Chinese Insurance Regulatory System.

Fundamental Assumption—1

That CIRC is undertaking, through measures to date and in the future, an approach consistent with the PRC's WTO obligations regarding market access, national treatment and transparency, and that the only discrimination (differences) between provisions for domestic and foreign insurance companies is where there is a clear and necessary prudential justification. Furthermore, that it is the goal of CIRC is to have one set of regulations and procedures for domestic and foreign companies, so that the regulations are consistent with China's WTO commitments.

Fundamental Assumption—2

That there are three (3) documents/rules/regulations relevant to this exercise. They are (working back from the present): (A) the Draft Insurance Company Administrative Regulations (hereinafter the "Measures."); (B) the Draft Trial Implementing Rules on the Regulations of the PRC on the Administration of Foreign-Invested Insurance Companies, July 31, 2003 (hereinafter "Implementing Rules"); and (C) The Administrative Regulations on Foreign-Invested Insurance Companies of the PRC, Feb. 2002 (hereinafter the "Administrative Regulations").

Fundamental Assumption—3

That the three documents are each intended to accomplish a specific regulatory function and that there is no intentional overlap or conflict between the provisions of the three documents, especially with regard to the application of measures as between domestic and foreign companies.

Fundamental Assumption—4

That only the "Implementing Rules;" and the "Administrative Regulations" are applicable specifically to foreign companies.

Fundamental Assumption—5

That the "Measures" are relevant to all companies both domestic and foreign equally without discriminatory interpretation.

IMPLEMENTATION GAPS

We would like written responses to three questions regarding gaps in the regulations where they should reference major elements of the implementation of China's WTO liberalization commitments:

Implementation Gap—1

It should be noted in the "Implementing Rules" that several existing joint venture companies have foreign registered capital interests that are above 50 percent. It should be confirmed that these companies, and any subsequent foreign companies approved by CIRC to own more that 50 percent, are grandfathered in accordance with China's WTO commitments, and that such companies will be allowed to expand geographically (through branches and sub-branches) in their current ownership structure.

Implementation Gap—2

Prior to China's WTO accession, a number of foreign insurance companies were allowed to establish operations in the PRC. All of these companies were requested by the Chinese Government to incorporate as operational branches, not as subsidiaries.

However, in both of the two new sets of draft regulations (the "Administrative Regulations," and the "Implementing Rules"), there does not appear to be any article that addresses the maintenance and development of these branch operations. We believe a section should be added explaining the administrative procedures under which a "guaranteed branch/sub-branch structure" should be allowed to operate. (By "guaranteed branch/sub-branch structure" we mean branches and sub-branches whose solvency is guaranteed and supported by the total assets of the parent company.) The branch/sub-branch structure is a well-established international norm appropriate for application in China. Accordingly, regulations should be developed to govern those branches already established in China and such future branches that may be established in China. We recommend that these regulations conform to the internationally accepted branch/sub-branch operating structure.

Indeed, in most countries and in accordance with international norms, when insurance companies enter foreign markets, they are allowed to establish an initial branch or home office and then expand to new locations throughout the country through a network of sub-branches. These sub-branches report to the original branch or home office.

This branch/sub-branch structure is supported by, and legally tied back to, its corporate parent. Thus, branch operations should not be treated as if they were separate, stand-alone entities. Likewise, because a branch/sub-branch structure is supported by its parent corporation's assets, the company should not have to recapitalize when expanding to a new location. This branch/sub-branch operating structure is an established international norm and a widely accepted principle of operation.

For property casualty insurance companies the ability to expand by sub-branch is particularly important. Foreign insurance companies should be allowed to expand geographically in the Chinese insurance market in accordance with established international norms and operating practices (i.e., through the use of the internationally accepted branch/sub-branch structure). Specifically, foreign insurance companies should be able to establish a branch (with a reasonable initial capitalization) backed up by the strength of the parent organization, and be allowed to expand throughout the country—in accordance with China's timetable for the phase-out of geographical restrictions—through the establishment of sub-branches. The establishment of sub-branches should not be limited to the immediate, licensed region or territory. Also, the company should not have to separately capitalize each new location.

We also request clarification with respect to branch boundaries. We believe that it is more efficient to establish provincial-level branches rather than only municipal-level branches. Domestic companies are able to operate at the provincial level with access to all cities and localities in the province. To date foreign companies have received approval to operate at only in one specific city. Foreign companies like their domestic counterparts should have provincial level licenses.

The proposed rules are also silent as to their impact on existing insurance company operations, including existing branches. It is, therefore, assumed that branches and other insurance company operations that exist today may, but are not required to, continue to operate under the conditions and approvals that existed prior to this rule, including but not limited to operations, financial structure, capital and mode of establishment. This understanding should be confirmed.

Implementation Gap—3

In addition to its insurance and reinsurance liberalization commitments, China committed to liberalize its pension market within 5 years of joining the WTO. To date, no regulations or laws have been released in anticipation of the opening of this important market sector. CIRC or other relevant authorities, should begin a public comment process well in advance of the approaching phase in deadline to gain the broadest level of comment and support for this fundamental undertaking.

NATIONAL TREATMENT QUESTIONS

In addition to the questions on fundamental assumptions and the further information needed to fill the implementation gaps, we would also like to receive confirmations from CIRC on the following specific questions regarding national treatment.

National Treatment Question—1

RE: Article 3 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly we interpret it to say that with respect to branch boundaries for foreign invested insurance companies, that they are treated the same as domestic companies which we understand are defined at the provincial-level (On May 21, CIRC approved Min Sheng Life to prepare 4 branches in Beijing, Nanjing, Hangzhou, and Shijiazhuang. (Source: China Insurance News, June 2003) If this is a correct understanding we believe that it is more efficient, and is a major step forward for CIRC in fulfilling their mission to implement China's WTO national treatment obligations. Domestic companies are able to operate at the provincial level with access to all cities and localities in the province. To date foreign companies have received approval to operate at only in one specific city. Foreign companies like their domestic counterparts should have provincial level licenses.

National Treatment Question—2

RE: Article 11 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly, we interpret it to say that with respect to branch applications for foreign invested insurance companies, that they are treated the same as domestic companies which we understand can apply for any number of branch approvals simultaneously with no limit to the number of branches a company may be granted at any given time.

National Treatment Question—3

RE: Article 13 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As there is no reference to any waiting period, we request confirmation in this article that no waiting period exists before licensed insurance companies, domestic or foreign, can apply for branch or sub-branch licenses.

National Treatment Question—4

RE: Article 99 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As it is so vague, we are concerned that Article 99 could be used to justify discrimination against foreign insurers, contrary to China's WTO commitments on national treatment. Accordingly, we would urge confirmation that the scope of Article 99 is limited solely to matters where the prudential justification will be clearly explained and limited to as least discriminatory as possible.

PRUDENTIAL JUSTIFICATIONS

In addition to the questions on fundamental assumptions, the further information needed to fill the implementation gaps, and questions of national treatment we would also like to receive responses from CIRC on the following questions of prudential justification.

Prudential Justification—1

RE: Article 6 (b) of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the capitalization requirements. We believe that RMB200 million is too prescriptive in nature and may be much higher than international norms with respect to specific business models and risks being assumed. We feel that CIRC should be granted the discretion to lower this amount where it feels appropriate. Also, we request clarification of the scope of the initial establishment of RMB 200 million. Please confirm that this includes the right to establish sub-branches without limitation as to numbers.

Prudential Justification—2

RE: Article 12 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the branching capitalization requirements of RMB20 million for each additional branch. We feel this is duplicative, contrary to China's WTO commitments, and has no prudential justification. Additionally we feel it is an inefficient use of capital, which will raise the cost of products to Chinese consumers.

In summary, it is vitally important that all parties work together in a clear and open manner to ensure understanding of CIRC's implementation process. Any measures China implements that give the impression of falling short of its WTO commitments and denying U.S. insurance companies meaningful market access in China could create hostility. Thus, it is in the interests of CIRC to continue a meaningful two-way dialog to make the implementation of China's WTO insurance commitments as smooth and positive as possible.

ACLI and our industry colleagues appreciate the hard work and high-level leadership of USTR and the other relevant U.S. Government agencies that have helped establish and grow this dialog with China. Likewise, the industry greatly appreciates the ongoing support of Members of Congress. We consider ourselves still at the beginning of a complex process, and will look forward to an ongoing relationship with your Commission as we proceed through the years to come. While we do not know when China's draft regulations will enter into force, it is our hope that our dialog, with your and the government's assistance, will produce a transparent and effective body of regulations comporting with China's strong and admirable WTO commitments. We will report to you as circumstances develop.

Thank you for your interest and consideration in this matter. I would be pleased to answer any questions that you may have.

American Council of Life Insurers

A recommendation for revisions to the capitalisation requirement rules for life insurance companies operating in China

ACLI

Prepared by:

Watson Wyatt Insurance Consulting Limited

10 December 2002

American Council of Life Insurers

A recommendation for revisions to the capitalisation requirement rules for life insurance companies operating in China

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1 Introduction

1.1 In accordance with the engagement letter dated 1 November 2002, Watson Wyatt Insurance Consulting Limited ("Watson Wyatt") has been engaged by American Council of Life Insurers ("ACLI") to produce a report on presenting a recommendation for revisions to the capitalisation requirement rules for life insurance companies operating in China (the "Report"). In our Report we have compared the capitalisation requirements of China with those of a number of other countries around the world, including the USA. We have also analysed a variety of financial projection models for different types of life insurance business models to assess the likely capital needs for various entry strategies. From these main areas of research and our experience of which regulatory regimes have worked well around the world, we have formed an opinion the type of capitalisation requirements that might be more appropriate for the China life insurance market.

1.2 In putting together this Report, Watson Wyatt has relied upon a variety of publicly available information and experience gained from many years of working in the life insurance markets in various regions throughout the world. Although independent verification of the information gathered was not undertaken, Watson Wyatt has reviewed certain information for reasonableness. Reliance is placed on but not limited to the accuracy of all information and data provided to us.

1.3 The Report does not purport to capture all of the activity currently underway in the various markets. Given the current state of rapid change in the insurance markets, especially in Asia, the opinions and conclusions with the Report should be considered extremely time sensitive.

1.4 This Report and the opinions and conclusions contained within, are for the sole use of ACLI, and not for any third party. It must be considered in its entirety, as individual sections, if considered in isolation, may be misleading. Distribution or disclosure of this Report to any other party is prohibited without the prior consent of Watson Wyatt. We will allow the Report to be distributed to ACLI member companies and to the CIRC and hereby give our express written consent. Consent will be given for distribution to other parties upon written application from the ACLI. Consent is given on the condition that Watson Wyatt accepts no responsibility, liability or duty of care to third parties and on the condition that the Report is distributed in its entirety. If ACLI wishes to disclose extracts from the Report in documents, Watson Wyatt needs to give prior written consent to the proposed wording. No reliance is to be placed on draft versions of this Report.

2 Executive summary

Objectives of capitalisation requirements

2.1 Capitalisation requirements for life insurance companies should safeguard the interests of policyholders in the early years of operation and this objective should be balanced against the importance of maintaining capital efficiency.

2.2 Capital needs in the early years of operation are likely to vary significantly according to the business model chosen, arguably the most important determinant of expected capital needs will be the distribution strategy adopted.

Impact of excessive capital requirements on the market

2.3 The higher the level of capital present in a business, the higher the level of profits required to support the cost of capital that has been injected into the business. Capital inefficiency arising from excessive capital requirements can impact adversely on the industry in a number of ways:

- Creates barriers to entry, stifling competition and slowing down improvement in pricing, service levels, market penetration and product and distribution innovation.
- Impacts on stability of market as companies supporting inefficient levels of capital can be tempted to pursue growth at all costs, often leading to very aggressive, agency poaching campaigns and generally unsustainable acquisition costs.
- Discourages capital-efficient alternative distribution models, slowing insurance penetration by leaving segments of the population untapped and removing the incentive for productivity improvements in traditional agency force distribution.
- Disadvantages smaller niche players, potentially delaying the development of specialist and innovative types of products.
- Impacts on pricing and competition as the costs of holding excess capital are passed on to the policyholder, giving large established players a significant pricing advantage and no incentive to improve efficiency.

2.4 Furthermore, the current limited domestic investment opportunities in China means that dormant capital in excess of solvency requirements cannot be invested for superior returns, therefore increasing the cost of capital inefficiency.

Determination of capitalisation requirements

2.5 There is no single capitalisation requirement that can be applied uniformly to all business models to safeguard solvency in the early years of operation with an equal degree of prudence for all companies.

2.6 In order to avoid capital inefficiency, appropriate capitalisation requirements should not be set to cover all possible capital needs of various business models in the early years of operation. Instead, increased reliance should be placed on the solvency regime which will force the gradual injection of additional capital as and when the initial capitalisation becomes insufficient to support the insurance risks of the growing company.

Summary of capitalisation requirements for life insurance operations in China

2.7 The current capitalisation requirements in China have two key features:

- different capitalisation requirements for national and regional licences
- capitalisation requirements upon entry plus additional capitalisation requirements that increase according to the number of branches

2.8 The minimum capitalisation requirement for life insurance operations in China is RMB200 million (US$24 million) for a regional licence and RMB500 million (US$60 million) for a national licence.

2.9 The branching capitalisation requirements mean that national licence companies must increase capitalisation by RMB50 million (US$6 million) for each additional branch in excess of 3, up to a ceiling of RMB1,500 million (US$181 million).

Issues with the structure of capitalisation requirements

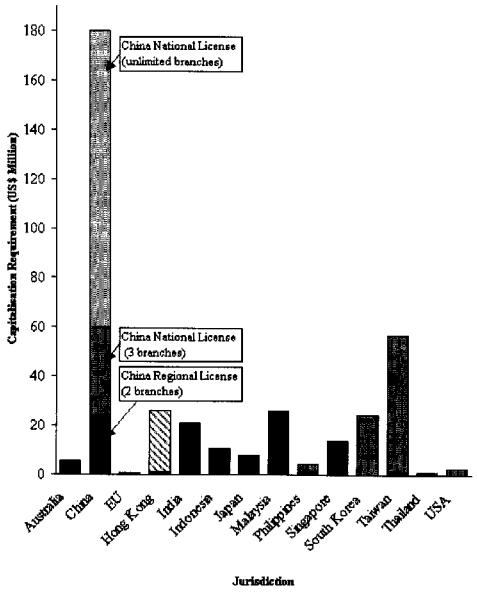
2.10 Life insurers in the early years of operation or planning market entry strategies commonly raise the following issues in respect of the current structure of capitalisation requirements:

- The effective capitalisation requirement for companies wanting to operate in more than one city is RMB500 million (US$60 million), not RMB200 million (US$24 million).
- Progress towards a high volume and more capital efficient operation by opening additional branches is hampered by the branch approval process that has, to date, been slow.
- Additional capitalisation requirements could continue for many years after entry if new branches are continually opened, and this delays or limits the profits available for distribution.
- The high capitalisation ceiling of RMB1,500 million (US$181 million) forces a large proportion of shareholder equity to be held as registered capital rather than retained earnings.

Issues with the magnitude of capitalisation requirements

2.11 The capitalisation requirements for life insurance operations in China appear excessive in relation to the United States, the European Union and 11 other Asian jurisdictions reviewed in this Report.

International capitalisation requirements for life insurance operations



- *Exchange rates as at 31 October 2002*
- *European Union will change to US$3 million from 2003*
- *Hong Kong US$26 million in practice*
- *Philippines ranges from US$1.4 to 4.7 million*
- *South Korea US$24.4 million for locally incorporated; US$0.1 to US$2.4 million for foreign branches*
- *Taiwan US$57 million for locally incorporated; US$1.4 million for foreign branches*
- *United States ranges from US$0.1 to US$2.5 million (Iowa and Michigan slightly higher)*

2.12 The lower capitalisation requirements for these international jurisdictions do not imply lower capital adequacy, as the respective solvency regime of each jurisdiction should ensure that adequate capital is maintained as the size and risks of the operation increase.

Level of capital likely to be needed in China

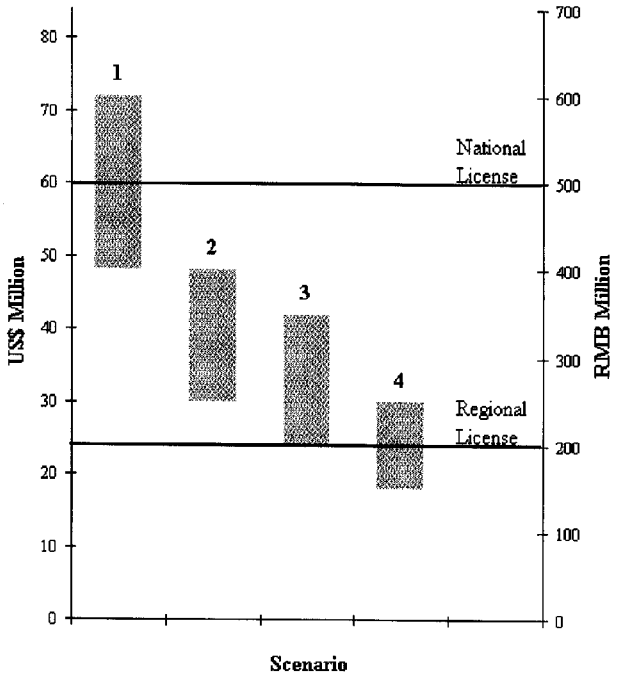
2.13 We have estimated aggregate capital injections required by a life insurance operation based on four different financial business models within the China market.

2.14 Capital needs in the early years of operation are likely to vary significantly according to the business model and the scale of operations. Therefore we have derived best estimate ranges based on four separate entry strategies.

- Scenario 1 mass market player with agency distribution model and a high proportion of traditional products
- Scenario 2 mass market player with agency distribution model dominated by non-traditional investment-linked products
- Scenario 3 bancassurance distribution model with a balance of traditional and non-traditional products
- Scenario 4 telemarketing/direct marketing distribution model with a low proportional of savings products

2.15 Estimated capital needs are based on an initial injection of RMB200 million plus any additional capital injections that emerge in the model to meet future solvency requirements. No additional capital injections to meet branching requirements are assumed and we assume there are no restrictions upon expansion in place for any scenario.

Estimated range of capital needs under four generic market entry strategies



- *Scenario 1* *mass market player with agency distribution model and a high proportion of traditional products*
- *Scenario 2* *mass market player with agency distribution model dominated by non-traditional investment-linked products*
- *Scenario 3* *bancassurance distribution model with a balance of traditional and non-traditional products*
- *Scenario 4* *telemarketing/direct marketing distribution model with a low proportional of savings products*

2.16 We conclude that the effective capitalisation requirement of RMB500 million (US$60 million) would be excessive for three of the four entry strategies reviewed. A capital intensive traditional agency force entry strategy may require some capital injection in addition to initial capitalisation under certain scenarios, but these additional injections are not expected to be required in the first five years of operation.

Recommendations for revision to capitalisation requirements

2.17 We recommend that capitalisation requirements for life insurance operations in China no longer be increased in line with the number of branches. If the branching capitalisation requirement is a proxy for scale of operations, we argue that more rapid expansion programmes will still be required to hold more capital due to higher solvency requirements.

2.18 We recommend that the magnitude of capitalisation requirement is lowered to reduce capital inefficiency and that the revised amount should be:

- Less than the expected needs of the most aggressive, capital-intensive entry strategies to avoid crowding out alternative business models;
- Less than the expected needs over the long term and more related to the expected needs in the first 3 to 5 years, allowing additional capital to be injected later if required;
- Sensitive to requirements in international jurisdictions, as these other markets are potential competitors for the assets available for potential investment; and
- High enough to reflect the potential difficulties and high uncertainty in a rapidly developing market like China.

2.19 On balance, we suggest consideration of a capitalisation requirement for life insurance operations of around RMB300 million (US$36 million). Although there is no precise methodology to arrive at this suggestion, we have taken the following factors into account:

- In the event that new entrants still choose to pursue the mass market, traditional agency force strategy, this level of capitalisation is estimated to cover expected capital needs for at least the first 3 to 5 years of operation.
- This level of capitalisation is estimated to exceed the expected capital needs of mass market agency distribution models if a less capital intensive mix of products is selected.
- This level of capitalisation is estimated to exceed the expected capital needs of most alternative distribution or focussed niche product business models.

- This level of capitalisation exceeds most of the Asian jurisdictions under review. In particular it is 1.7 times the requirement in India, another rapidly developing and recently liberalised market.
- This level of capitalisation is considerably higher than the minimum for established international jurisdictions such as Australia, United States and the European Union.

2.20 The above points illustrate a level of prudential caution in the suggested revision of life insurance capitalisation requirements to RMB300 million (US$36 million). Despite this remaining level of prudence, the suggested capitalisation requirement is generally lower than current levels (for example, a 10-branch operation requirement would be 35% of current requirements). This reduction in effective capitalisation requirements should greatly reduce the potential over-capitalisation of the market, encourage investors and help promote a greater variety of product, distribution and scale strategies.

2 执行概要

资本金要求的目的

2.1 人寿保险公司的资本金要求的目的是在公司营运初期保障保单持有人利益，与此同时，此目的应与维持资本效益的重要性作出平衡。

2.2 营运初期资本金要求很可能因为所选取的经营模式的不同而有显著区别，而分销策略可以被认为是决定未来资本金要求的最重要因素。

过高资本金要求对市场的影响

2.3 业务中流通的资本越多，需要用以维持已注入资金的成本的利润就越高。因过高资本金要求而导致的低资本效益可在下列方面对行业造成不利影响：

- 造成市场进入障碍，压抑竞争，并减缓在价格、服务水平、市场渗透以及产品及分销创新方面的发展。
- 由于维持低效益资本的公司有可能被诱以不惜一切代价追求业务增长，而导致严重保险经纪挖角战及产生通常不可衍续的初始成本，对市场稳定性造成一定的影响。
- 由于不鼓励具有资本效益的其它分销模式，使得一些市场消费群体未被发现，同时使得传统保险经纪人失去提高工作效率的积极性，以至减缓保险市场的渗透。
- 不利于比较小的及走专门路线的保险公司的发展，亦有可能延缓专业及创新型产品的开发。
- 因持有过剩资本的成本转嫁到保单持有人，使实力雄厚的大型公司具备显著价格优势及丧失提高效益的动力，对价格及竞争造成影响。

2.4 此外，由于中国现时国内投资机会有限，超过偿付能力要求的闲置资本无法获得丰厚利润，因此增加了低效益资本的成本。

资本金要求的决定

2.5 没有一种资本金要求能完全适合所有经营模式，并以同等审慎态度保证所有公司都能维持营运初期的偿付能力。

2.6 为避免低资本效益，合理的资本金要求不应以满足所有经营模式在早期任何可能情况下的资本金需求而设。相反，应加强偿付机制，从而强行使得公司在初始资本金不足以承担保险风险时逐渐注入额外资本。

中国寿险业资本金要求概要

2.7 中国现时资本金要求有以下两个主要特点：

- 国家性及地区性执照资本金要求不同
- 市场进入资本金要求加上因分支机构数目增长而增加的额外资本金要求

2.8 在中国特定区域内经营业务的保险公司最低资本金要求为2亿元人民币(24,000,000美元)，在全国范围内经营保险业务的保险公司最低资本金要求为5亿元人民币(60,000,000美元)。

2.9 分支机构资本金要求是指对于拥有三家或以上分支机构的全国性保险公司，每新增一家分支机构需增加资本金5000万元人民币(6,000,000美元)，直到资本金达到15亿元人民币(181,000,000美元)。

资本金要求架构上的问题

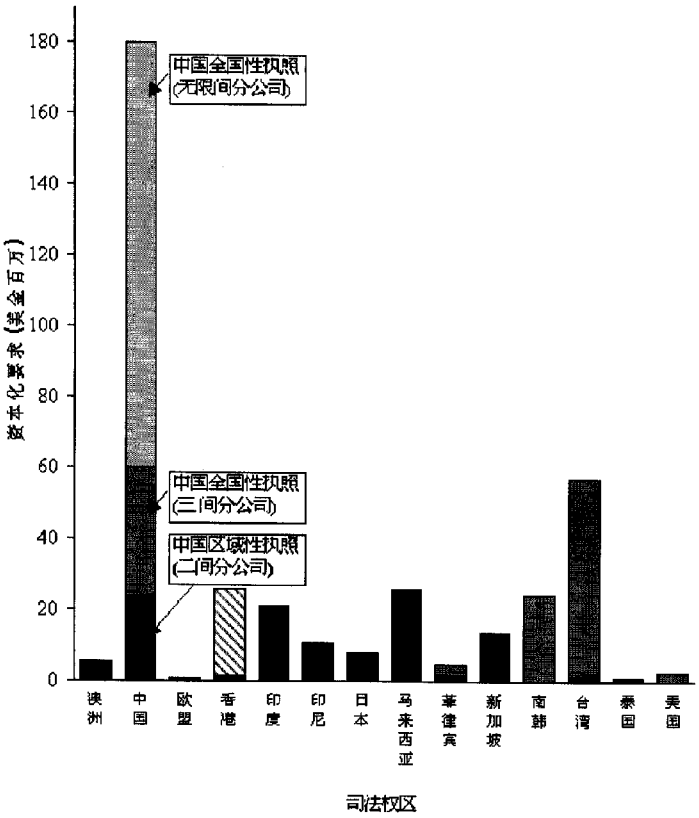
2.10 处于营运初期或正在进行市场进入策略规划的保险公司通常会就现时资本金要求架构提出以下问题：

- 计划在多个城市经营的保险公司的资本金要求实为5亿元人民币(60,000,000美元)，而非2亿元人民币(24,000,000美元)。
- 通过开设新分支机构以提高业务量及资本效益的进度受分支机构认可流程牵制，而该流程迄今仍较缓慢。
- 继续开设新分支机构所带来的额外资本金要求可持续多年，此情况会延缓或限制可分配利润。
- 15亿元人民币(181,000,000美元)的高资本限额使大部份股东权益以注册资本而非未分配利润的形式持有。

资本金要求大小上的问题

2.11 中国人寿保险营运资本金要求与亚洲其他11个司法权区、美国及欧盟相比呈现过高。

人寿保险营运国际资本金要求



- *以2002年0月31日之汇率计算*
- *欧盟资本金要求将于2003年变为,000,000美元*
- *香港资本金要求实际为6,000,000美元*
- *菲律宾资本金要求为,400,000至,700,000美元*
- *南韩外商分支机构资本金要求为00,000至,400,000美元，本地注册成立公司为4,400,000美元*
- *台湾外商分支机构资本金要求为,400,000美元，本地注册成立公司为7,000,000美元*
- *美国资本金要求为00,000至,500,000美元Iowa州和Michigan州要稍稍高一些*

2.12 随著营运规模及风险增加，各司法权区的偿付机制将确保维持充足资本，故这些国际司法权区资本金要求较低并不代表资本充足性低。

可能适合中国的资本金水平

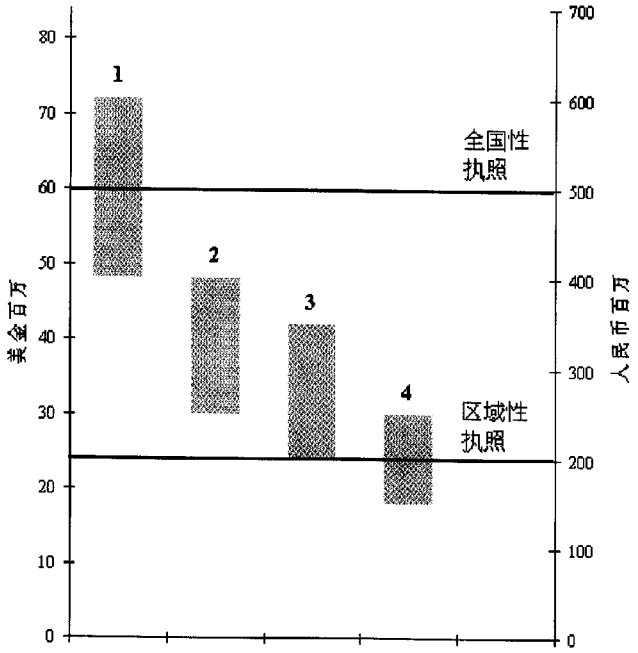
2.13 本公司据四种不同财务经营模式估计出在中国经营一家保险公司所需注入的总资本额。

2.14 运作初期的资本需求可能会因经营模式及运作规模而有显著区别。因此，本公司根据四种不同市场进入战略得出最优估计范围。

- 方案1 采用保险经纪分销模式，以传统寿险产品为主，并以大众市场为主导的保险公司
- 方案2 采用保险经纪销售模式，以投资连接的非传统产品为主，并以大众市场为主导的保险公司
- 方案3 采用银行保险分销模式，传统及非传统产品参半
- 方案4 采用电话销售／直销分销模式，产品中储蓄型产品只占少部分

2.15 估计的资本金要求包括最初注入的2亿元人民币及于经营过程中因需达到未来偿付要求而注入的额外资本。在计算时，我们假设无需注入分支机构所需的额外资本及在扩展上没有地方限制。

四类市场进入战略下预计的资本金要求



方案

- *方案1* 采用保险经纪分销模式，以传统寿险产品为主，并以大众市场为主导的保险公司
- *方案2* 采用保险经纪销售模式，以投资连接的非传统产品为主，并以大众市场为主导的保险公司
- *方案3* 采用银行保险分销模式，传统及非传统产品参半
- *方案4* 采用电话销售／直销分销模式，产品中储蓄型产品只占少部分

2.16 本公司认为5亿元人民币（60,000,000美元）的资本金要求对所分析的四个市场进入战略中的三个均过多。资本密集型的传统保险经纪战略在一定的情况下可能需要注入初期投资外的额外资本，但预料最初五年营运中是无需此类额外资本的注入的。

对资本金要求的修改建议

2.17 本公司认为目前中国寿险业的资本金要求不应随分支机构的数目的增长而增加。若分支机构额外资本金要求是用作代表营运规模，本公司认为在公司更快速的发展过程中，因要满足更高偿付能力要求事实上已对资本金有了更高的要求。

2.18 本公司建议降低资本金要求，以改善低资本效益的状况，其修改後的数额应：

- 少于最激进的资本密集型的市场进入策略的预计需要量，以避免排挤其他经营模式；
- 少于长期的预计需要量，最好接近最初三至五年的预计需要，容许在日後在需要时注入额外资本；
- 关注国际司法权区的资本金要求，因这些市场将是潜在的投资上的竞争者；并且
- 足够充足以反映出中国这样快速发展市场的潜在困难及高度不确定性。

2.19 综上所述，本公司建议考虑大约为3亿元人民币（36,000,000美元）作为人寿保险业的资本金要求。尽管此建议并非由精确方法计算所得，但本公司亦已考虑下列因素：

- 若新加入者仍选择进入大众市场，采用传统保险经纪策略，该资本金水平预计应至少满足最初三至五年预期营运资本所需。
- 若选择资本密集较低的混合保险产品，该资本金水平预计应超过以大众市场为主及用保险经纪分销模式的预计资本要求。
- 该资本金水平预计应超过大多数选择其他分销或走专门产品路线经营模式的预计资本要求。
- 该资本金水平超过大多数经过我公司审核的亚洲司法权区水平，尤其是其为印度要求的1.7倍，印度为另一个快速发展及刚刚开放的市场。
- 该资本金水平大大高于已有基础的例如澳大利亚，美国及欧盟等国际司法权区的最低水平。

2.20 上述论点表明将人寿保险资本金要求改为3亿元人民币（36,000,00美元）的建议是保留有一定的审慎水平的。虽然如此，此建议的资本金要求还是普遍低于目前的资本金要求（例如，对于一个拥有10家分支机构的公司来说，建议资本金要求为目前要求的35%）。减少资本金要求将大幅减少潜在的市场上资本金过剩的现象、鼓励投资者、并有助于促进产品、分销及规模策略多元化。

3 Regulatory capitalisation requirements

Overview

3.1 Capitalisation requirements for life insurance companies should safeguard the interests of policyholders in the early years of operation and this objective should be balanced against the importance of maintaining capital efficiency.

3.2 Capital needs in the early years of operation are likely to vary significantly according to the business model chosen, arguably the most important determinant of expected capital needs will be the distribution strategy adopted.

3.3 Capitalisation requirements that create capital inefficiency can adversely impact the development of a market stifling competition and deterring innovation in product and distribution. The costs of inefficient levels of capital are likely to be passed on the policyholders. An overcapitalised market can lead to instability as companies aggressively pursue market share in an attempt to build sufficient volume to support their capital.

3.4 In order to avoid capital inefficiency, appropriate capitalisation requirements should not be set to cover all possible capital needs of various business models in the early years of operation. Instead, increased reliance should be placed on the solvency regime which will force the gradual injection of additional capital as and when the initial capitalisation is no longer sufficient to support the insurance risks as the company writes more business.

3.5 Appropriate capitalisation requirements should be set to provide a floor to underpin the solvency requirements in the early years of operation. It is not expected that the regulator will use discretion to impose different requirements upon different applicants. Therefore, the floor should be more than a nominal amount. The most appropriate magnitude for this floor is a question of judgement and cannot be determined by some precise formula.

Terminology and scope of recommendations

3.6 The objective of the Report is to investigate and recommend alternative capitalisation requirements for life insurance operations in China. We define "capitalisation requirements" as the amount of assets that a company is required to inject in order to obtain approval to commence a life insurance business in the jurisdiction.

3.7 We use the term "solvency requirements" to refer to the ongoing level of assets in excess of liabilities that an insurer is required to maintain. This may also be referred to as the solvency regime. Additional terminology that we have adopted throughout the Report is set out in Appendix A.

3.8 Any other aspects of regulatory licensing requirements (including the form of capital and any specific deposit requirements) are beyond the scope of this Report.

Objectives of capitalisation requirements

3.9 In our opinion, the primary objective of capitalisation requirements is to reasonably ensure that an insurer can fulfil its obligations and thereby safeguard the interests of policyholders in the early years of operation. It is important to balance this objective against the importance of maintaining capital efficiency.

3.10 In many markets around the world the regulations are designed such that ongoing solvency requirements for a growing life insurance company will, at some point, exceed the amount of capital remaining from initial capitalisation. It is common for this to occur after the first few years of operation. The solvency of mature companies will thereafter be safeguarded by the statutory solvency requirements present in that jurisdiction.

3.11 Solvency requirements work as a buffer to protect the insurer and the policyholders against losses from unexpected events. The appropriateness of solvency requirements is beyond the scope of this Report but in the following discussion regarding capitalisation requirements, we assume that a prudent solvency regime that suitably reflects the risks of individual companies is in place.

3.12 In certain jurisdictions, capitalisation requirements may also be used to encourage a certain scale of operations, a higher level of commitment or to create implicit barriers to entry for smaller companies. Whilst such issues regarding the suitability of the investor may concern the regulator, this Report concentrates on the primary objective of safeguarding solvency. Other licensing requirements, for example relating to external capital resources and insurance expertise of the investor, are commonly used to more directly address such regulatory concerns.

Capital needs in the early years of operation

3.13 A life insurance company, whether mature or recently established, will face a variety of risks and capital is needed to meet solvency requirements designed to provide a buffer against those risks. The solvency regime, including any minimum solvency requirements, will generally dictate the level of capital that a company is required to hold, although many companies elect to hold more capital than the minimum and many regulators require companies to hold more than the minimum.

3.14 An appropriate level of capital will depend upon the particular features of a life insurer's business model, including:

- sales compensation strategy
- distribution strategy
- expense structure

- volume of business sold
- type of products sold
- other operating aspects of the business model of the individual insurer

3.15 Companies in the early years of operation are also likely to require capital for the following reasons:

- ***Infrastructure costs***: A certain amount of expenditure is needed to develop the physical infrastructure necessary to operate a life insurance company. As with any new business, such start-up costs may not be recovered from profits until several years into the operation of the company and in the interim will need to be met out of initial capitalisation (or additional capital injections).
- ***New business strain***: In the early years after policy inception, distribution costs will often exceed the early year premium income resulting in short term negative cashflow. Also, depending on the regulatory regime, the company may need to establish statutory technical reserves that exceed cashflows and contain an element of prudence to be released in later years. The overall affect is a "new business strain" for the policy where capital is required to support the sale of the policy. For a company in the early years of operation the total new business strain cannot be offset by profits emerging from more mature policies. The resulting statutory losses in the early years of operation will be met out of initial capitalisation (or additional capital injections). If sales exceed expectations, more capital injections may be required to meet higher than expected new business strain.
- ***Expense overruns***: A company will sell products priced using expense loadings that assume a certain scale of operations. In the early years of the operation, the scale of business is likely to be lower than the level implicit in the expense pricing assumptions and the consequent expense overruns will be met out of initial capital (or additional capital injections). If sales fall short of expectations, even more capital may be required to meet higher than expected expense overruns.

3.16 Capital needs in the early years of operation are likely to vary significantly according to the business model. Arguably the most important factor determining the actual amount of capital that will be needed is the distribution model. For example, a company planning a mass market agency force distributing traditional products with high distribution costs and exposure to risks that require significant technical reserves is likely to have significantly high capital requirements. Whilst the main distribution model in China is currently the agency model, there are a number of alternative models which are being tried and are proving successful in the Asian region. These include bancassurance (which is becoming more prevalent in China), direct marketing/telemarketing, worksite marketing and salaried financial planners. These various strategies can exhibit vast differences in capital requirement.

3.17 The number of branches is likely to have a lesser impact on capital needs than the expenses associated with the level of national infrastructure that the company needs to establish before extending or duplicating the model into new regions. As the company matures, the risks that the insurer faces and hence the likely capital requirements are more related to the volume and type of business written, which may, or may not, depend on the number of branches. This implies that the capital needs for a new branch may well be able to be met with initial capital and retained earnings, thus removing the requirement to have a separate capital injection to support branching activity.

Impact of excessive capital requirements on the market

3.18 Insurance companies, like all commercial entities, must generate returns for their shareholders in order to attract and retain investment capital. The higher the level of capital present in a business the higher the level of profits required to support the cost of the capital that has been injected into the business.

3.19 If capitalisation requirements are set at a high level suitable for a large scale operation, then newly established or smaller companies may be required to hold more capital than is really necessary to provide a reasonable level of protection against the inherent risks of the business.

3.20 This capital inefficiency or necessity to hold "dormant" capital, can impact on the industry in a number of ways:

- ***Barrier to entry*** – It should not be assumed that overly high capitalisation requirements will only dissuade companies with low capital resources from entering the market in China. Potential investors with deep capital resources may decide that their projected business prospects in China will not provide adequate returns to support the cost of capital and elect to invest elsewhere. Other potential investors may be prepared to commit the levels of capital required but would be unwilling to inject the capital in advance of the business growth. Barriers that lead to fewer players in a large and fast growing market may slow down improvement in pricing, service levels, market penetration as well as product and distribution innovation.

- ***Impact on stability*** – An overly capitalised insurance market may appear to afford greater protection to policyholders but should capital requirements become excessive they can actually be a driver of market instability. Companies who must support levels of capital that are inefficient for all but the largest players can be tempted to pursue growth at all costs, often leading to very aggressive, agency poaching campaigns and generally unsustainable acquisition costs. As agents move from company to company their clients are also "churned" or switched resulting in acquisition costs being paid more than once and policyholders ultimately bearing the cost. Regulators are then put under pressure due to

increasing numbers of complaints from both companies and policyholders. Experience shows that it is usually only the agents that benefit from such an environment.

- ***Discouragement of alternative distribution models*** – Those players using less capital-intensive forms of distribution may also find overly high capitalisation requirements wholly unsuitable for their business model. The consequent high levels of "dormant" capital held would be a major deterrent to implementing non-agency distribution plans and such models which may have enhanced the development of the overall market. For example, bancassurance distribution, if implemented correctly, can be significantly less capital-intensive than traditional agency distribution and these business models are rapidly expanding throughout the Asian region. The success of bancassurance in many markets has helped increase insurance penetration, tapping into new segments of the population. New forms of distribution strategy are often copied by the traditional players allowing them to extend their reach and to diversify the risks of traditional channels. Also, an insurance market where multiple distribution strategies are employed creates competitive pressure on the inefficiencies of traditional channels, which in turn creates an incentive for significant productivity improvements in agency force distribution and expense management.

- ***Disadvantage to niche players*** – Excessive capitalisation requirements may lead potential investors to decide that the only business models likely to generate sufficient returns to support that capital are mass-market, agency distribution strategies offering traditional products and using geographical reach to generate sufficient scale. Players seeking to pursue niche offerings to certain segments of the population are less likely to enter the market given the excessive cost of capital for their projected size of operations. This can retard the development of specialist and innovative types of products leaving certain segments of the population without products that are attractive to their needs.

- ***Impact on pricing*** – In a liberalised market, the cost of capital is passed on to policyholders through the pricing mechanism. New entrants forced into supporting large amounts of dormant capital will therefore need to charge higher premiums in order to generate appropriate return for that capital. Mature players, with more efficient levels of capital for their scale of business can outprice new entrants, stifling competition and its associated advantages. Alternatively mature companies may also charge higher premiums converting their scale advantage into additional profits rather than policyholder savings. More typically, overly high capitalisation requirements can allow mature companies to continue to operate inefficiently without fear of competition from more efficient new entrants who are operating at a capital structure disadvantage.

- ***Limited uses for dormant capital*** – Investors in insurance may be prepared to hold excessive capital in the short term until the business reaches a sufficient size to support the cost of capital, provided they can achieve a reasonable return on that dormant capital to minimise the opportunity cost. In a market where investments in respect of excess capital are restricted by regulation or limited by investment environment, this becomes a less attractive strategy.

Determination of capitalisation requirements

3.21 There is no single capitalisation requirement that can be applied uniformly to all business models to safeguard solvency in the early years of operation with an equal degree of prudence for all companies. A capitalisation requirement that is set high enough to provide for future expected capital needs for the most capital intensive entry strategies under a variety of experience scenarios will likely be excessive for other strategies and other experience outcomes.

3.22 In view of the long term nature of life insurance, business capital needs for the "early years of operation" may in effect relate to expected injections over a period of 8 to 10 years or longer. A single up-front capitalisation requirement that covers those expected capital needs means that capital is injected into the business prior to being needed, creating the sort of capital inefficiency discussed above.

3.23 Suitable solvency requirements are often a better instrument than capitalisation requirements for ensuring that an insurance company is holding sufficient capital as a buffer against adverse experience. This is because solvency requirements often better reflect the individual insurers exposure to risks as they are generally based on policies written (if not on a more rigorous risk-based capital approach). Solvency requirements are concerned with the magnitude of assets less liabilities at the time of assessment, making allowance for losses sustained subsequent to the initial capitalisation. They are more prospective in nature than the concept of initial capitalisation.

3.24 The other advantage to relying on solvency requirements to ensure that a suitable buffer is in place is that they force capital injections gradually in line with the actual capital needs of the business. Allowing company shareholders to inject capital as required improves the capital efficiency of their investment. The China regime with a gradual increase of capitalisation requirements in line with new branches is less effectively matched with actual capital needs.

3.25 There is still, however, a need to have capitalisation requirements that provide a "floor" that is not dependent on the magnitude of solvency requirements. Solvency margins that relate to business written do not necessarily create a buffer for risks not reflected in the solvency regime basis. For example, when low volumes are being written or the products have minimal solvency margins, a buffer is still required to protect against other risks for example, as overspending on infrastructure. It is also

necessary to protect the policyholders in the event that the investors do not want to make additional capital injections and sufficient resources must be applied to transfer or terminate the business.

3.26 In order to avoid capital inefficiency, appropriate capitalisation requirements should not be set to cover all possible capital needs of various business models in the early years of operation. Instead, increased reliance should be placed on the solvency regime which will force the gradual injection of additional capital as and when the initial capitalisation is no longer sufficient to support the insurance risks as the company writes more business.

3.27 Appropriate capitalisation requirements should be set to provide a floor to underpin the solvency requirements in the early years of operation. It is not expected that the regulator will use discretion to impose different requirements upon different applicants. Therefore, the floor should be more than a nominal amount. The most appropriate magnitude for this floor is a question of judgement and cannot be determined by some precise formula.

3.28 We would consider capitalisation amounts that are:

- Less than the expected needs of the most aggressive, capital-intensive entry strategies to avoid crowding out alternative business models;
- Less than the expected needs over the long term and more related to the expected needs in the first 3 to 5 years, allowing additional capital to be injected later if required;
- Sensitive to requirements in international jurisdictions, as these other markets are potential competitors for the assets available for potential investment; and
- High enough to reflect the potential difficulties and high uncertainty in a rapidly developing market like China.

4 Current regulatory capitalisation requirements in China

Overview

4.1 The minimum capitalisation requirement for life insurance operations in China is RMB200 million (US$24 million) for a regional licence or RMB500 million (US$60 million) for a national licence increasing to a ceiling on capital requirements of RMB1,500 million (US$181 million).

4.2 Life insurers in the early years of operation or planning market entry strategies commonly raise the following issues in respect of the current structure of capitalisation requirements:

- The effective capitalisation requirement for companies wanting to operate in more than one city is RMB500 million (US$60 million), not RMB200 million (US$24 million).
- Progress towards a high volume and more capital efficient operation by opening additional branches is hampered by the branch approval process that has, to date, been slow.
- Additional increasing capitalisation requirements could continue for many years after entry if new branches are continually opened, and this delays or limits the profits available for distribution.
- The high capitalisation ceiling of RMB1,500 million (US$181 million) forces a large proportion of shareholder equity to be held as registered capital rather than retained earnings.

Capitalisation requirement structure

4.3 The majority of the legislation governing life insurance operation capitalisation requirements is obtained from the Insurance Administration Rules ("the Rules") issued by the China Insurance Regulatory Commission ("CIRC") and effective 1 March 2000.

4.4 The current capitalisation requirements in China have two key features:

- different capitalisation requirements for national and regional licences
- capitalisation requirements upon entry plus additional capitalisation requirements that increase according to the number of branches

4.5 The underlying solvency regime is based on a statutory reserve valuation basis plus a prescribed solvency margin.

Regional and national licences

4.6 Insurance companies can obtain either a regional or a national licence to commence life insurance operations in China. The regional licence allows a company to open up to 2 additional branches without further capitalisation and a national licence allows a

company to open up to 3 additional branches without further capitalisation. In both cases, additional branches are subject to regulatory approval. To date no foreign-funded companies have been issued with a national company licence upon entry to the market.

4.7 The regions open to foreign-funded entities were initially restricted to the cities of Shanghai and Guangzhou, although there are now another five cities where approval has been permitted and all regions are scheduled be opened over the next 4 years.

Minimum capitalisation requirements

4.8 The minimum capitalisation requirements under Article 7 of the Rules are as follows:

- national company RMB500 million (US$60 million)
- regional company RMB200 million (US$24 million)

Branch restrictions

4.9 An insurance company, whether it is national or regional, must obtain approval from the CIRC to open additional branches. Approval for expansion is contingent upon fulfilment of capital requirements as outlined in Article 13 of the Rules, plus being able to meet solvency requirements and other criteria as set out by the CIRC. To date the approval process for additional branches has not been rapid with only 4 foreign-funded entities being granted approval for any additional branches.

4.10 A regional company is confined to the region of the licence and furthermore cannot open an additional branch where the head office is located under Article 12 of the Rules.

Branching capitalisation requirements

4.11 A company that wishes to expand beyond the number of branches permitted under the initial licence (2 for regional, 3 for national) is required under Article 13 of the Rules to increase its registered capital by RMB50 million (US$6 million) for each additional branch up to a maximum of RMB1,500 million (US$181 million).

4.12 The maximum capitalisation requirement of RMB1,500 million (US$181 million) therefore applies to national companies operating a head office plus 23 or more branches. There are currently 5 domestic life insurance companies in China with more than 23 branches.

Statutory reserve valuation basis

4.13 In accordance with the reserving regulations prescribed by the CIRC in 1999, we understand that for policies with a term greater than one year ("long term business") the minimum reserves should be calculated using a prospective basis and assumptions as used in pricing.

4.14 Whole of life annuity insurance is based on a modified net level premium method (with revised mortality assumptions). A net premium 1 year full preliminary term basis is used for remaining traditional long term business. The CIRC has issued provisional regulations for investment linked business, where the reserve is basically set to be equal to the account balance.

4.15 The reserves for policies with a term of 1 year or less ("short term business") are calculated as 50% of the gross premium.

Solvency requirements

4.16 The solvency requirements for long term business under Article 84 of the Rules prescribe a solvency margin in addition to statutory reserves as follows:

- 4% of statutory reserves for non investment linked business
- 1% of statutory reserves for investment linked business
- an amount related to the sum at risk being:
  - 0.3% of the amount at risk for benefit terms longer than five years
  - 0.15% of the amount at risk for benefit terms between 3 and 5 years
  - 0.1% of the amount at risk for benefit terms shorter than 3 years.

4.17 The solvency requirements for short term business under Article 83 of the Rules prescribe a solvency margin in addition to statutory reserves equal to 18% of the first RMB100 million of premium income, and 16% on the excess premium.

4.18 There is no minimum solvency requirement.

Statutory deposit reserve

4.19 Insurance companies are required to deposit 20% of total registered capital in a designated bank upon establishment, under Article 78 of the Insurance Law (and Article 13 of the Foreign-Funded Insurance Companies Rules effective 1 February 2002.) This deposit requirement does not impact on the capitalisation requirements.

Other shareholder reserves

4.20 According to Financial Regulations for Insurance Companies, additional reserves such as the Statutory Revenue Reserve and the Common Welfare Fund must be set up out of accumulated retained earnings, before dividends can be paid to shareholders. The reserves are to be built up from net profit after accumulated losses have been covered, until they reach 50% of the registered capital. We understand that the rate of funding for each reserve is between 5% and 10% of net profits.

4.21 The Statutory Revenue Fund and the Common Welfare Fund do not force companies to make additional capital injections. However, for a more mature company with positive returned earnings and solvency requirements that are well below minimum capital, these reserves will increase the overall level of capital that must be held, and hence delay the payment of dividends to shareholders.

Comments on the China capitalisation requirements

4.22 Overall, the capitalisation requirements for life insurance operations in China exceed requirements in the international jurisdictions reviewed in Section 5 of this Report, in some cases by significant amounts. The magnitude also exceeds the expected capital requirements under a range of potential market entry scenarios as discussed in Section 6 of this Report.

4.23 Life insurers in the early years of operation or planning market entry strategies commonly raise the following issues in respect of the current structure of capitalisation requirements:

- ***Effective minimum of RMB500 million (US$60 million)*** – the entry licences granted to foreign-funded entities to date have been regional licences in the "regions" of Shanghai or Guangzhou. This has meant that the first branch must be in another city and hence another region, requiring a national licence and hence a minimum capital of RMB500 million.
- ***Increasing capital efficiency is dependent on branch approval*** – the RMB50 million capitalisation requirement for each additional branch is low relative to the national licence requirement of RMB500 million (US$60 million) for the first 3 branches. This suggests that for many operations, the more branches that can be opened, the larger the potential market and the business model moves towards capital efficiency. However, to date the process of obtaining additional branch approval has been slow, prolonging the period of capital inefficiency.
- ***Long term requirement to increase capitalisation*** – the national licence requirement to increase capital for each additional branch in excess of 3 could mean that the investors seeking to open additional branches are continually required to make capital injections or convert retained earnings into registered

capital for many years into the future. If this capital is not required to meet solvency requirements it will delay or limit the opportunity for distributions to shareholders.

- ***Requirement to hold shareholder equity as registered capital*** – the very high RMB1,500 million (US$181 million) ceiling on capitalisation means that mature companies are forced to hold shareholders equity in the form of registered capital even if that capital has been built up from retained earnings from sustainable profits. This capital structure may reduce flexibility and be unattractive to the shareholders.

5 International capitalisation requirements

Overview

5.1 In this section, we demonstrate that the capitalisation requirements for life insurance operations China appear excessive in relation to the international jurisdictions under review.

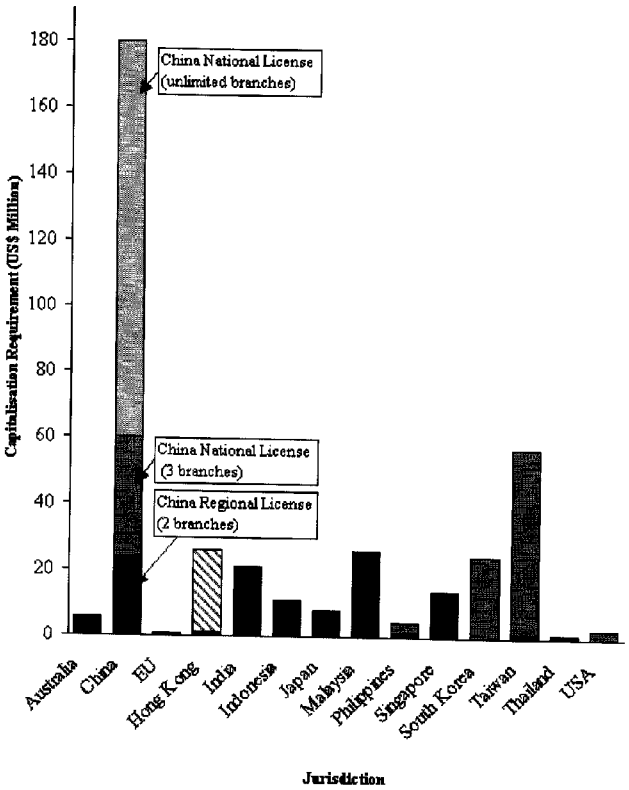
5.2 The capitalisation requirements for the jurisdictions range from US$0.1 million to US$57 million. The China national licence capitalisation requirement of around US$60 million is higher than all jurisdictions under review. Capitalisation requirements for all jurisdictions in our review are significantly lower than the US$181 million ceiling on capitalisation requirements in China.

5.3 The lower capitalisation requirements for these international jurisdictions does not imply lower capital adequacy as the solvency regime should ensure that adequate capital is injected or retained in the companies.

International jurisdictions

5.4 The capitalisation requirements for life insurance operations in the United States, the European Union and 11 selected Asian jurisdictions are graphically presented below and compared with those that exist in China.

International capitalisation requirements for life insurance operations



- *Exchange rates as at 31 October 2002*
- *European Union will change to US$3 million from 2003*
- *Hong Kong US$26 million in practice*
- *Philippines ranges from US$1.4 to 4.7 million*
- *South Korea US$24.4 million for locally incorporated; US$0.1 to US$2.4 million for foreign branches*
- *Taiwan US$57 million for locally incorporated; US$1.4 million for foreign branches*
- *United States ranges from US$0.1 to US$2.5 million (Iowa and Michigan slightly higher)*

5.5 The table below expands on the simplification of the graphical representation and includes a brief summary of the solvency regime:

Jurisdiction		Life Insurance Company Capitalisation Requirement	Life Insurance Company Solvency Regime
Australia	:	US$5.5 million (A$10 million)	Revaluation of policy liabilities on conservative assumptions.
Hong Kong	:	US$1.3 million (HK$10 million) Practice is for US$26 million	EU solvency, regulatory expectation at 150% level.
India	:	US$21 million (Rs1,000 million)	EU solvency, regulatory expectation at 150% level.
Indonesia	:	US$11 million (Rp100 billion)	RBC solvency requirement (phasing in)
Japan	:	US$8.1 million (¥1 billion)	Prescribed solvency risk margins, asset revaluation.
Malaysia	:	US$26 million (RM100 million)	Modified EU solvency
Philippines		US$1.4 to 4.7 million (₱75 to ₱250 million)	0.2% of the amount of insurance with a minimum of US$0.01 million (₱0.5 million)
Singapore	:	US$14 million (S$25 million)	Modified EU solvency
South Korea	:	US$24.4 million for locally incorporated companies (KRW30 billion) and US$0.1 to US$2.4 million for foreign branch (KRW3.6 billion)	Modified EU solvency (phasing in)
Taiwan	:	US$57 million for locally incorporated companies (NT$2 billion), and	New solvency requirements on a RBC method expected in 2003

Jurisdiction		Life Insurance Company Capitalisation Requirement	Life Insurance Company Solvency Regime
		US$1.4 million for foreign branches (NT$50 million)	
Thailand	:	US$1.2 million (Bt50 million)	Modified EU requirement
USA	:	US$0.1 to 2.5 million (Iowa, Michigan higher)	RBC solvency Subject to minimum
EU	:	US$0.8 million (€0.8 million); US$3 million from 2003	Prescribed risk margins based on statutory valuation and sum at risk

Exchange rates as at 31 October 2002 as documented in Appendix C.

Comments regarding the summary of international jurisdictions

5.6 Certain companies may elect to capitalise above their respective requirements based on business decisions and independently of any regulatory pressure. Regulators in certain jurisdictions often have authority to exercise discretion to impose higher requirements. Licensing requirements usually require submission of business plans. Those regimes with modest capitalisation requirements may suggest additional capitalisation after consideration of projected expected capital needs. This summary is concerned with the statutory requirement which acts as a minimum.

5.7 None of the jurisdictions under review in this Report require an increase in capital as a result of an increase in geographical location (i.e. branching). The closest parallel is the US where authorisation to operate in each state is granted on a state-by-state basis. However in the US, whilst the total registered capital requirement must meet the minimum of each state, it is not cumulative across each state where the insurer is licensed. Furthermore, the magnitude of each state minimum in the United States is substantially lower than the magnitude of capitalisation requirements in China.

5.8 Solvency regimes are generally more complex in practice than summarised in the above table.

5.9 The remainder of this section provides additional detail regarding each international jurisdiction. More detailed elements of each international solvency regime such as the specified form of capital or the basis on which assets and liabilities are valued for solvency purposes are excluded from this brief summary.

Australia

5.10 Capitalisation requirement of A$10 million (US$5.5 million).

5.11 The solvency regime requires insurers to meet both a solvency standard and a capital adequacy standard. To quantify these standards, valuation of policy liabilities is to be calculated on three bases:

- a best estimate basis;
- a prescribed basis for solvency purpose; and
- a prescribed basis for capital adequacy purpose (more conservative than the solvency basis).

5.12 There is no deposit requirement.

Hong Kong

5.13 Capitalisation requirement of HK$10 million (US$1.3 million).

5.14 Solvency margin calculation of sum of 4% of policy reserves for traditional products, with a lower percentage possible for investment linked products and 0.3% of sum at risk. For rider type products the solvency margin calculation is the higher of a prescribed percentage of premium or claims. The calculation can be reduced for reinsurance subject to a limit. The solvency requirement is subject to a minimum amount of HK$2 million (US$0.3 million).

5.15 We understand that the regulator has minimum capital internal rules of HK$200 million (US$26 million) raising the effective capitalisation requirement. Companies are also expected to target a 150% of the solvency requirements and to demonstrate that expected future capital levels meet target in the three-year business plan.

5.16 There is no specified deposit requirement. However, the regulator has discretion to require the insurer to make a deposit.

India

5.17 Capitalisation requirement of Rs1,000 million (US$20.7 million).

5.18 Solvency margin calculation of a percentage (generally 4%) of policy reserves plus a percentage (generally 0.3%) of sum at risk. The actual percentages used vary by types of life insurance contracts. The solvency requirement is subject to a minimum of Rs500 million (US$10 million). We understand that the regulator expects companies to target 150% of the solvency margin.

5.19 Deposit requirement of the lesser of Rs100 million (US$2.1 million) and 1% of the total gross premium written in the last financial year, deposited with the Reserve Bank of India.

Indonesia

5.20 Capitalisation requirement of Rp2 billion (US$0.2 million) and Rp4.5 billion (US$0.5 million) for local companies and foreign joint ventures respectively provided they commenced operation before 1999. Companies which commence operation after 1999 are subject to a capitalisation requirement of Rp100 billion (US$11 million).

5.21 Solvency margin requirement equal to a multiple of a risk margin.

- The risk margin is calculated on a prescribed basis, taking into account the sum of the Investment Default Risk, Duration Mismatch Risk, Currency Mismatch, Claims Risk, Investment Return Deviation Risk and Reinsurer Default Risk.
- The multiple of the risk margin increases over a five-year period. The multiple increases from 40% as at the end of 2001, 75% as at the end of 2002, 100% as at the end of 2003 to 120% from the end of 2004.

5.22 Deposit requirement of 20% of the capitalisation requirement.

Japan

5.23 Capitalisation requirement for mutual and stock companies is ¥1 billion (US$8.1 million).

5.24 Solvency margin requirement to hold adjusted surplus at least equal to the statutory minimum capital. The statutory minimum capital is 200% of a risk margin. The risk margin is calculated on a prescribed basis, and is a function of Insurance Risk, Assumed Interest Risk, Asset Management Risk and Management Risk.

5.25 The current deposit requirements are as follows:

- minimum ¥1 billion for local companies
- ¥10 million for foreign-funded companies transacting only foreign currency business with US troops.
- ¥200 million for other foreign-funded companies.

Malaysia

5.26 Capitalisation requirement of RM100 million (US$26 million). This was recently increased from RM50 million (US$13 million).

5.27 Solvency margin calculation of sum of 4% of policy reserves and a percentage 0.2% of sum at risk. The solvency margin requirement is subject to a minimum of RM50 million (US$13 million).

5.28 There is no deposit requirement.

Philippines

5.29 Capitalisation requirement for an existing life insurance company of ₱50 million (US$0.9 million) with contributed surplus of ₱2 million, requirement for a new domestic life insurance company of ₱75 million (US$1.4 million), with contributed surplus of ₱25 million (US$0.5 million). Capitalisation requirement for new foreign subsidiaries (i.e. non-Philippines domestic companies) are as follows:

- Foreign equity of at least 60%:
  - ₱250 million (US$4.7 million) capitalisation requirement and ₱50 million (US$0.9 million) contributed surplus.
- Foreign equity of more than 40% but less than 60%:
  - ₱150 million (US$2.8 million) capitalisation requirement and ₱50 million contributed surplus.
- Foreign equity of 40% or less:
  - ₱75 million (US$1.4 million) capitalisation requirement and ₱25 million contributed surplus.

5.30 Solvency margin requirement of 0.2% of total insurance amount in force (except term insurance) as of the preceding calendar year with a minimum of ₱500,000 (US$0.01 million).

5.31 Companies must deposit 25% of the capitalisation requirement with the regulator as a security fund. This security fund requirement is ₱300 million (US$5.6 million) for new foreign branch operations.

Singapore

5.32 Capitalisation requirement of S$25 million (US$14 million).

5.33 Solvency margin requirement the higher of:

- 3% of policy reserves plus 0.2% of sum at risk plus 50% of net premium income for accident and health plans in preceding accounting period
- S$5 million (US$2.8 million)

5.34 Deposit requirement of S$500,000 (US$0.3 million) deposited with the Monetary Authority of Singapore.

South Korea

5.35 Capitalisation requirement of KRW30 billion (US$24 million) for locally incorporated companies. For foreign branches, the capitalisation requirement is:

- KRW3 billion (US$2.4 million) or more in the case of a foreign insurer intending to conduct insurance business for Korean nationals and foreigners in Korea
- KRW500 million (US$0.4 million) or more in the case of a foreign insurer to conduct insurance business mainly for foreigners in Korea
- KRW100 million (US$0.1 million) or more in the case of a foreign insurer intending to solicit insurance from foreigners in Korea as its main business

5.36 Solvency margin requirement of 4% of reserve plus a "coefficient of insurance risk" multiplied by sum-at-risk.

5.37 The coefficient of insurance risk is defined as follows:

$$\text{risk premium} \div \text{face amount}$$

$$\times \Sigma \left\{ \begin{array}{l} \text{(each risk) claims paid ratio x (each risk) proportion of claims paid} \\ \text{x (each risk) company charge ratio (allowing for reinsurance)} \end{array} \right\}$$

5.38 The solvency margin level calculated is to be phase-in as follows:

End of Month	Rate
September 2002	62.5%
March 2003	75.0%
September 2003	87.5%
March 2004	100.0%

5.39 Deposit requirement of 30% of capitalisation requirement.

Taiwan

5.40 Capitalisation requirement of NT$2 billion (US$57 million) for locally incorporated companies and NT$50 million (US$1.4 million) for foreign branch licences.

5.41 Prior to 9 July 2003, the solvency margin requirement is at least 3 times the deposit amount prior to 9 July 2003. The rule does not apply to the foreign branch if it meets the following conditions:

- Excess of admitted assets over liabilities meets the minimum working capital of NT$50 million (US$1.4 million); and
- Its overseas parent company meets the solvency margin requirement of the domestic company and has sound financial status.

5.42 From 9 July 2003 onwards, insurers will be subject to a risk-based capital approach to solvency margin, which will apply equally to foreign branch companies (except for foreign re-insurers meeting certain financial and operating criteria). The risk-based capital system is currently under review, and our understanding of the current draft is as follows:

- Life insurers are required to hold adjusted surplus at least equal to the statutory minimum capital.
- The statutory minimum capital is expected to be calculated as 200% of a risk margin. The risk margin is calculated on a prescribed basis, and is a function of Asset Risks of subsidiaries and non-subsidiaries, Insurance Risks, Interest Risks, and Other Risks.

5.43 Deposit requirement of NT$300 million (US$8.6 million) and NT$7.5 million (US$0.2 million) for domestic and foreign branch respectively (i.e. 15% of capitalisation requirement) in bonds at the National Treasury.

Thailand

5.44 Capitalisation requirement of Bt50 million (US$1.2 million) for existing companies. New companies are subject to a capitalisation requirement of Bt500 million (US$11 million).

5.45 Solvency margin or "capital fund" (defined to be the excess of assets over liabilities, making it a solvency margin equivalent) requirement of the greater of 2% of reserves and Bt50 million (US$1.2 million).

5.46 There is currently a proposal to increase the capital fund requirement to the greater of 4% of reserves and Bt500 million (US$11 million). The proposed timeframe for the increase requires companies to increase their solvency margins to Bt300 million (US$6.9 million) within three years and Bt500 million (US$11 million) within five years. Sources within the industry have the understanding that as the regulations can be changed relatively easily, the new level with phase-in has been removed. While this is still unclear at time of writing this Report, an increase to the solvency margin is probably not unlikely.

United States of America

5.47 Capitalisation, deposit and solvency requirements for life insurance operations as provided by the ACLI for the various states in the US are shown in Appendix B.

5.48 Capitalisation requirements range between US$0.1 million and US$2.5 million with Louisiana and Virgin Islands requiring US$0.1 million, whereas Iowa and Michigan are exceptions to this with requirements of US$5 million and US$7 million respectively. Most commonly the capitalisation requirement for a particular state is around US$1 million.

5.49 In order to operate in more than one jurisdiction, a US life insurer is not required to aggregate the Capitalisation requirements from each state where they are licensed. Therefore, in principal, a capitalisation of US$7 million should be sufficient to apply for a licence in all states.

5.50 Although the US is comprised of a number of separate insurance jurisdictions, solvency regulation has been harmonised by the National Association of Insurance Commissioners ("NAIC") Financial Standards and Accreditation Program. As a result the majority of US states have moved to a risk based capital ("RBC") solvency regime where risk margins are determined separately for different categories of risk based on the specific exposures of each company. The solvency requirements calculated using an RBC approach are often subject to a minimum solvency requirement. Minimum solvency requirements vary between states and may be as high as the initial capitalisation minimum.

5.51 There are deposit requirements in each state, which are generally expressed as a fraction of the capitalisation requirement. These deposit requirements may be cumulative between certain states.

European Union

5.52 The rules regarding solvency requirements in most country within the European Union are largely the same as the minimum requirements set down by the European Union ("EU").

Capitalisation requirements

5.53 Capitalisation requirements in the EU are described in terms of a "guarantee fund" This guarantee fund is defined as the minimum of one third of the required minimum solvency margin, subject to a minimum of the "minimum guarantee fund". This is currently defined as €600,000 (US$0.6 million) for mutual life insurers and €800,000 (US$0.8 million) for shareholder-owned life insurers.

5.54 Note that the EU has, this year, amended the requirement for the minimum guarantee fund, which will increase to €3 million (US$3.0 million) for all types of insurer, this amount increasing each year with inflation. The size of the first tranche used in the "premiums basis" calculation (see section 5.57) used for rider business will increase from €10 million (US$9.8 million) currently to €50 million (US$49.2 million) indexed with inflation. Member states must implement these changes in regulations by September 2003, although insurers may be given up until 2007 to fully comply with the higher requirement.

Required minimum solvency margin

5.55 For non-linked life insurance business except riders, the required minimum solvency margin is defined as the sum of:

- The "first result", equal to the product of 4% of the mathematical reserves, and the ratio of reserves net of reinsurance and reserves gross of reinsurance (subject to a minimum ratio of 85%), plus
- The "second result", equal to the product of 0.3% of the capital at risk and the ratio of capital at risk after reinsurance and capital at risk before reinsurance (subject to a minimum ratio of 50%)

5.56 For term assurances with a maximum period of three years, the factor of 0.3% applied to the capital at risk is replaced by 0.1%. For term assurances with a maximum period of more than three years but less than five, the factor is 0.15%, otherwise the 0.3% applies.

5.57 For rider business the required minimum solvency margin is calculated on the "premiums basis", as follows.

- The total premiums written in the year for direct business and reinsurance acceptances, less cancelled premiums and premium taxes are calculated.
- This amount is split into two parts – the first tranche (currently up to a total of €10 million (see section 5.54)) is multiplied by 18%, and the second tranche (any amount in excess of €10 million) is multiplied by 16%.

- The sum of these amounts is multiplied by the ratio of the last year's claims net of reinsurance to claims gross of reinsurance (subject to a minimum ratio of 50%).

5.58 For investment linked life insurance business, excluding riders, the required minimum solvency margin is defined as:

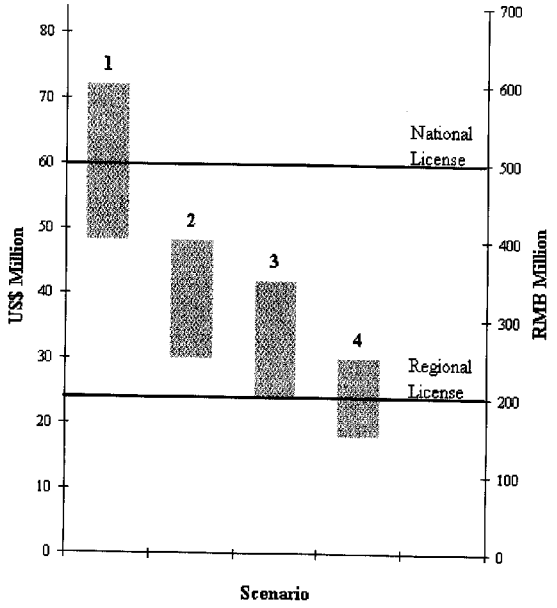
- if the insurer bears investment risk, an amount equal to 4% of the mathematical reserves before reinsurance multiplied by the ratio mentioned in the "first result" above
- if the insurer bears no investment risk, an amount equal to 1% of the mathematical reserves before reinsurance multiplied by the ratio mentioned in the "first result" above, but only if the insurance contract has a period of over five years, and the deduction to cover management expenses in the contract is fixed for a period of more than five years
- if the insurer bears not investment risk an amount equivalent, to 25% of the last financial years' net administrative expenses, but only if the insurance contract has a period less than 5 years and the deduction to cover management expenses in the contract is not fixed for a period exceeding 5 years
- if the insurer bears mortality risk, the margin obtained from the previous two bullet points is increased by an amount equal to 0.3% of the capital at risk, multiplied by the ratio defined in the "second result" above.

6 Capital needs in China

Overview

6.1 In this section, we provide guidance on the level of capital likely to be utilised by a life insurance company in early years of operation in China, and how this may vary depending on the different distribution and product strategies adopted. The results of our financial projection work are summarised below:

Estimated range of capital needs under four generic market entry strategies



- *Scenario 1* *mass market player with agency distribution model and a high proportion of traditional products*
- *Scenario 2* *mass market player with agency distribution model dominated by non-traditional investment-linked products*
- *Scenario 3* *bancassurance distribution model with a balance of traditional and non-traditional products*
- *Scenario 4* *telemarketing/direct marketing distribution model with a low proportional of savings products*

Financial models

6.2 Our views are based on practical business planning and operational experience with a variety of life insurers in, and potential life insurance market entrants to, the China insurance market and other markets throughout the Asian region.

6.3 We have looked at the results of a variety of financial models that have been built around different entry strategies although we have not developed fully specified financial models within the scope of this Report. We have used these models to estimate expected capital needs for a sample of generic entry strategies. We have estimated, for each scenario, the range of aggregate capital injections required over early years of operation until the entry strategies can fund further expansion out of retained earnings.

6.4 Our models commence with an initial capitalisation of RMB200 million. Additional capital, if required, is subsequently assumed to be injected according to the solvency requirements emerging from the particular entry strategy. We have assumed that capital is not injected to comply with branching requirements. The aggregate capital injection is not highly sensitive to whether the entire requirement is injected at commencement of operation or over the early years of operation.

6.5 The product strategies are broadly represented by a combination of five products that are described in Appendix D. The distribution strategies will drive the expense assumptions that vary in line with the different entry strategies.

6.6 A brief summary of the type of actuarial and other assumptions typically underlying these models for the China market is set out in Appendix D. Our models are based on best estimate assumptions and therefore our estimates of likely capital needs also represent best estimates.

Generic entry strategies

6.7 The expected capital needs in the early years of operations will vary widely among insurers, typically depending upon the business model adopted with key factors being the distribution and product strategies adopted. The scale of operations envisaged may also be a key factor but for certain business models, capital needs can be quite insensitive to premium volume.

6.8 We have outlined four generic entry strategies which, while not all-encompassing, demonstrate a wide range of likely capital injection requirements based on the reserving and solvency margin requirements currently in place in China:

- Scenario 1 mass market player with agency distribution model and a high proportion of traditional products

- Scenario 2 mass market player with agency distribution model dominated by non-traditional investment-linked products
- Scenario 3 bancassurance distribution model with a balance of traditional and non-traditional products
- Scenario 4 telemarketing/direct marketing distribution model with a low proportional of savings products

Estimated capital needs

6.9 The details of each strategy together with the models' results are discussed below.

Scenario 1

6.10 This scenario represents the predominant business model currently found in China. It is based on a mass-market agency distribution model with high ongoing distribution costs. A full range of products would be sold, but usually with a bias towards traditional participating contracts which are generally more capital intensive.

6.11 We have looked at model results arising from various expansion programmes that generate up to RMB2 billion (US$240 million) premium over the first five years and up to RMB10 billion (US$1.2 billion) premium per annum by a year ten of operations. These scale of operations implicitly assume that a more liberalised branching approval process will be in place to enable expansion. We have also looked at slower growth strategies as these can sometimes require even higher capital support in initial years.

6.12 We estimate that total expected capital injections would be in the range of RMB400 million to RMB600 million (US$48 million to US$72 million), depending largely on the scale of operations and the speed of expansion.

Scenario 2

6.13 This scenario assumes the same mass-market agency distribution channel as scenario 1 but is based on a product strategy that excludes traditional products in favour of investment linked products. Whilst the distribution model and expense structure is similar, this model is less capital intensive because of the lower solvency requirements of investment linked products and hence the lower reserving strain in the first year of operation. Also, under current conditions in China, investment linked products appear to be more profitable than traditional savings products, further reducing expected capital injections.

6.14 We considered slightly higher expected premium volumes compared to scenario 1, reflecting higher expected average premiums from investment linked products.

6.15 We estimate total expected capital injections to be in the range of RMB250 million to RMB400 million (US$30 million to US$48 million), depending both on the expansion programme and future profitability trends for investment linked products.

Scenario 3

6.16 This scenario assumes a bancassurance distribution model. Bancassurance models are being implemented throughout Asia and have recently been introduced to the China market. Distribution costs could be significantly lower than scenarios 1 and 2 and capital needs would be reduced because of the consequently lower new business strain. We have considered accompanying product strategies that include a fair proportion of traditional products, so it is possible that capital needs could be further lowered if the bancassurance operation focused on investment linked products and yearly renewable accident and health products.

6.17 The total expected capital injections for this type of scenario are estimated to be RMB200 million to RMB350 million (US$24 million to US$42 million). These estimates are based upon consideration of both mass-market and smaller volume bancassurance strategies. In view of the less capital intensive nature of the model, the scale of the strategies does not have as great an impact on expected capital needs.

Scenario 4

6.18 This scenario assumes an alternative distribution (e.g. telemarketing/direct marketing) approach. While such models are not currently present in China, they are becoming increasingly popular throughout Asia, and may also be considered for the China market in the future. Distribution costs generally involve high infrastructure expenditure but substantial savings on ongoing distribution costs. Product strategies are often biased towards health and accident products and some simple traditional savings products.

6.19 The total expected capital injection required to support such a strategy is estimated to be in the range of RMB150 million to RMB250 million (US$18 million to US$30 million). In other words the initial capitalisation of RMB200 million is exceeds the total capital requirements of the entry strategy under some variations of the scenario. These estimates are based on generally lower volume strategies than the other scenarios.

7 Reliances and limitations

Reliances

7.1 In putting together the Report, Watson Wyatt relied upon a variety of publicly available information and experience gained from many years of working in insurance markets of China and around the world. Although independent verification of published information was not undertaken, Watson Wyatt has reviewed certain information for reasonableness. Reliance is placed on but not limited to the accuracy of all data provided.

7.2 In respect of the information pertaining to life insurance companies in the United States market, Watson Wyatt relied upon the accuracy of the data provided by ACLI in the following documents:

- NAIC's Compendium of State Laws on Insurance Topics: "Capital and Surplus Requirements for Companies";
- NAIC's Compendium of State Laws on Insurance Topics: "Company Deposit Requirements";
- Summary of State deposit requirements for foreign insurers to transact life business; and
- ACLI's memorandum entitled "Research on International Solvency Requirements" dated 17 May 2002.

Limitations

7.3 This Report and the opinions and conclusions contained within, are for the sole use of ACLI, and not for any third party. It must be considered in its entirety, as individual sections, if considered in isolation, may be misleading. Distribution or disclosure of this Report to any other party is prohibited without the prior consent of Watson Wyatt. We will allow the Report to be distributed to ACLI member companies and to the CIRC and hereby give our express written consent. Consent will be given for distribution to other parties upon written application from the ACLI. Consent is given on the condition that Watson Wyatt accepts no responsibility, liability or duty of care to third parties and on the condition that the Report is distributed in its entirety. If ACLI wishes to disclose extracts from the Report in documents, Watson Wyatt needs to give prior written consent to the proposed wording. No reliance is to be placed on draft versions of this Report.

7.4 This Report has been prepared on the basis as set out in the Report and its appendices. It has been written on the basis that it will be utilised by persons technically competent in the areas addressed and with knowledge of the subject of life insurance. Judgements as to the information contained in the Report should be made only after studying the Report in its entirety, as conclusions reached by review of a section or sections on an isolated basis may be inappropriate. Furthermore members of Watson Wyatt's staff

are available to explain and/or amplify any matter presented herein, and it is assumed that the user of this Report will seek such explanation and/or amplification as to any matter in question.

7.5 The Report does not purport to capture all of the activity currently underway in the various markets. Given the current state of rapid change in the insurance markets, especially in Asia, the opinions and conclusions with the Report should be considered extremely time sensitive.

Limit of liability

7.6 The total liability of Watson Wyatt arising out of or in connection with the subject matter of our reports in contract or tort or otherwise (in each case including, but not limited to, negligence) shall be limited to a maximum of US$3 million.

Legal jurisdiction

7.7 This Report will be governed by and construed in accordance with English law and the parties submit to the exclusive jurisdiction of the English courts in connection with all disputes and differences arising out of, under or in connection with this Report. If any part of a provision of this Report is held invalid, illegal or unenforceable then the remainder of such provision shall remain valid and enforceable to the fullest extent permitted by law.

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10 December 2002

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A Terminology

Capitalisation requirement

1 We use the term capitalisation requirement to refer to the amount of assets that a company is required to inject in order to obtain approval to operate a life insurance business in the jurisdiction. This capitalisation may also be referred to as initial registered capital or initial paid-up capital. The majority of jurisdictions specify capitalisation as a single absolute amount while a few jurisdictions may specify different amounts to different companies according to prescribed rules.

2 In certain jurisdictions, companies entering into the market inject more initial capital than the statutory capitalisation requirement. This additional capital may have been requested or suggested by the regulator as part of the licence approval process or may have been a decision made by the investors. In this Report we consider the legislated statutory amount to be the capitalisation requirement unless we are aware of a specific statement made by the regulator requiring an explicit amount of capitalisation in excess of the statutory amount.

Solvency requirements

3 We use the term solvency requirement to refer to the level of assets in excess of liabilities that an insurer is required to maintain. This requirement may also be referred to as the solvency regime. The solvency requirement must be met out of registered capital plus retained earnings and may be subject to an absolute minimum level. This may also be referred to as the solvency regime. The solvency requirement works as a buffer to protect the insurer and the policyholders against losses from unexpected events.

4 In practice the regulator may expect companies to target some multiple of solvency (e.g. 150%) which effectively increases the solvency requirement.

Solvency margin

5 Solvency requirements are often expressed as a solvency margin in excess of statutory reserves. The solvency margin is commonly defined in relation to the policies that have been written (e.g. a percentage of sum insured, premium, reserves). Recently, more jurisdictions are moving to express solvency requirements as the difference between the statutory reserves and the level of reserves required to withstand a variety of "stress-tests" relating to the risks of individual company (also referred to as a risk-based capital approach to solvency).

Capital/minimum capital

6 We use the term "capital" to refer to shareholder equity, comprised of registered capital, retained earnings and any other reserves that are deemed to belong to the shareholders. The minimum amount of capital required at any point in time is usually determined by the solvency requirements. However, in the early years of operations,

the registered capitalisation less retained losses may exceed solvency requirements, particularly if the initial capitalisation requirement was very high.

7 We use the term "minimum capital" in this Report to refer to the minimum applicable to a particular company at a particular point in time. Therefore, it is not an absolute amount but a function of capitalisation requirements, solvency requirements, minimum solvency requirements and the actual experience of the company over time.

8 In practice, companies elect or may be required to hold more than the minimum capital. They may hold this excess as either registered capital or retained earnings for a variety of reasons that will vary between companies. The reasons may relate to the shareholder structure, historic events, desire for additional prudence, planned future uses of capital and other circumstances. In this Report, unless otherwise stated, a reference to the level of capital should be interpreted as a reference to minimum capital as defined by the capitalisation and solvency requirements.

Deposit requirement

9 Regulators usually place restrictions on the type of assets that an insurer must hold. Deposit requirements are more specific restrictions that generally require the insurer to deposit a certain proportion of registered capital with the state bank or some other highly secure asset.

B Summary of capital and solvency requirements for the US

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Alabama	$800,000 New domestic stock life insurer $1,000,000	$800,000 $1,200,000 if has not transacted business for 5 years New domestic stock life insurer $1,000,000 Subject to RBC	Stock insurer Smaller of $100,000 or minimum paid-in capital stock required to be maintained Mutual insurer Smaller of $100,000 or surplus	$100,000 (Commissioner shall accept proper certificate from any other state that like deposit is being maintained there)
Alaska	$1,000,000	Additional surplus when first authorised $1,000,000 Additional maintained surplus $750,000 Subject to RBC	$300,000	$300,000 (Commissioner shall accept proper certificate from any other state that like deposit is being maintained there)
Arizona	$300,000	$150,000 Subject to RBC	Stock insurer Greatest of: Minimum required capital stock 2/3 of aggregate reserves 25% of the earned premium of the prior year Mutual insurer Greatest of: Minimum required basic surplus 2/3 of aggregate reserves 25% of the earned premium of the prior year But no deposit shall exceed $500,000	Stock insurer Greatest of: Minimum required capital stock 2/3 of aggregate reserves 25% of the earned premium of the prior year Mutual insurer Greatest of: Minimum required basic surplus 2/3 of aggregate reserves 25% of the earned premium of the prior year But no deposit shall exceed $500,000.

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Arkansas	$750,000	$112,500 (15% of capital) Subject to RBC	$100,000 In addition, each insurer shall deposit securities to guarantee any final judgement rendered against the insurer. Amount is based on admitted assets: $0 to $250,000—$50,000 minimum deposit 250,001 to 500,000—75,000 minimum deposit 500,001 to 1 million—100,000 minimum deposit over 1 million—150,000 minimum deposit	None (effective 1/1/02)
California	$2,250,000	$2,250,000 (100% of capital) Subject to RBC	Life insurer shall maintain a special deposit of securities for the benefit of registered policies.	Life insurer shall maintain a special deposit of securities for the benefit of registered policies.
Colorado	$1,500,000	$1,500,000 Subject to RBC	$1,500,000	$1,500,000
Connecticut	$1,000,000	$2,000,000 Subject to RBC	No provision.	No provision.
Delaware	$300,000	$150,000 Subject to RBC	$100,000	$100,000
District of Columbia	$1,000,000 Mutual N/A	$500,000 (50% of capital) $1,500,000 for Mutual Subject to RBC	$100,000. At the discretion of the commissioner may be as low as $25,000 for a domestic insurer.	$100,000 (Deposit may be made with supervisory official of any state or territory, and certificate of deposit shall be filed with commissioner)
Florida	Initial surplus $2,500,000	Maintenance surplus $1,500,000 Subject to RBC	Stock insurer $100,000 Additional deposit up to $2 million may be required (with determination of deteriorating financial conditions or lack of preservation of policyholder interests) Mutual insurer $200,000	$100,000 Deposit not required for insurer with surplus as to policyholders of more than $10 million. Additional deposit up to $2 million may be required (with determination of deteriorating financial conditions or lack of preservation of policyholder interests)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Georgia	Initial capital or minimum surplus $1,500,000 Additional capital or surplus $1,500,000	Maintain larger of paid-in capital or 50% paid in capital or stock Subject to RBC	$100,000	$100,000 (Insurer may present certificate that a like deposit has been made in another state. Commissioner may also require insurers to deposit between $10,000 and $25,000 in securities)
Hawaii	$600,000	$300,000 (50% of capital) Subject to RBC	Stock insurer Paid-up capital stock (=$600,000) Mutual insurer Unimpaired surplus (=$600,000)	Stock insurer Greater of paid-up capital stock or $500,000 Mutual insurer Greater of surplus required of a like domestic insurer or $500,000 (Commissioner shall accept certificate from another state showing deposits maintained there by that insurer)
Idaho	$1,000,000	$1,000,000 Subject to RBC	Stock insurer Minimum capital (=$1,000,000) Mutual insurer Basic surplus (=$1,000,000)	$1,000,000 (or a certificate that an insurer has made a like deposit in another state and is in good standing with appropriate guaranty association instead)
Illinois	Stock insurer $1,000,000 capital $1,000,000 initial surplus Mutual insurer $2,000,000 initial surplus	Stock insurer $500,000 maintenance surplus Mutual insurer $1,500,000 maintenance surplus Subject to RBC	Stock insurer Required minimum capital and surplus. (=$2,000,000) Mutual insurer Required minimum surplus. (=$2,000,000)	Amount equal to that required for domestic insurers (or a similar deposit made with another state)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Indiana	Paid-in capital for stock insurer $200,000 if organised prior to March 7, 1967 $400,000 if organised prior to July 1, 1977 $1,000,000 if organised after June 30, 1977 Minimum surplus for mutual insurer not mentioned	Initial / Maintenance Surplus $1,000,000 / $250,000 for stock insurer $2,000,000 / $1,250,000 for mutual insurer Subject to RBC	Stock insurer 25% of paid-in capital if organized before July 1, 1977 10% of paid-in capital if organized after June 30, 1977 Mutual insurer $25,000 if organized before June 30, 1955 $50,000 if organized after June 29, 1955 but before March 7, 1967 $100,000 if organized after March 6, 1967. Life insurer Smaller of reserve value/liabilities or $1,000,000 (or greater amount as deemed necessary) when added to deposits required under other sections No deposit required until amount prescribed exceeds amount otherwise required for stock and mutual insurers.	Smaller of reserve value/liabilities or $1,000,000 (Foreign insurers may present a certificate indicating the company maintains a like deposit in the state of domicile)
Iowa	$5,000,000	$5,000,000 Subject to RBC	Required capital and surplus. (=$5,000,000)	Required capital and surplus. (=$5,000,000)
Kansas	$600,000 Mutual N/A	$600,000. $1,200,000 for Mutual Subject to RBC	$400,000	$400,000 (if a company has such a deposit with another state, Kansas will not require one)
Kentucky	$1,000,000	$2,000,000 Subject to RBC	Assets not less than valuation of all policies in force less any sums advanced to policyholders. No further deposit required if legal reserve or valuation of all policies in force equals $20 million.	Assets not less than valuation of all policies in force less any sums advanced to policyholders. (Foreign insurer may present a certificate that they have a deposit of like quality and amount maintained in another state)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Louisiana	$100,000	For companies admitted prior to Sept 1, 1989 $200,000 surplus For companies admitted on or after Sept 1, 1989 $1,900,000 minimum surplus $1,000,000 operating surplus Subject to RBC	Securities equal to legal reserve for all outstanding policies in force	Same for domestic insurers. [$100,000 ?]
Maine	$1,500,000 paid-in capital or basic surplus	$1,500,000 initial free surplus Subject to RBC	$100,000	$100,000 (insurer may provide instead a certificate that it has at least $100,000 on deposit in another jurisdiction)
Maryland	$200,000 if commencing business before July 1, 1965 $500,000 if commencing business before July 1, 1991 $1,500,000 if commencing business on or after July 1, 1991 $750,000 for any insurer after June 30, 2001, which qualified to engage in business before July 1, 1991	Minimum required = % of minimum capital: 50% if commencing business before July 1, 1966 100% if commencing business after June 30, 1966 150% for new insurers Subject to RBC	$100,000	$100,000 (insurer may provide instead a certificate that a like amount is deposited in another state)
Massachusetts	Paid-up capital $400,000	Paid-surplus $800,000 Mutual in surplus $1,200,000 Subject to RBC	[No requirement?]	[No requirement?]
Michigan	Insurers admitted after July 1, 1965 must have $7,000,000 unimpaired capital and surplus as of Jan 1, 1999	Insurers admitted after July 1, 1965 must have $7,000,000 unimpaired capital and surplus as of Jan 1, 1999 Subject to RBC	$300,000 or a larger amount as the commissioner considers appropriate.	$300,000 (no deposit required if maintains deposit in the state of domicile in the same amount and for the same purposes as required for domestic insurers)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Minnesota	$1,000,000	Initial / Maintenance Surplus $2,000,000 / $1,000,000 Subject to RBC	Lesser of securities with market value of at least $500,000 or 50% of the capital and surplus requirements.	Lesser of securities with market value of at least $500,000 or 50% of the capital and surplus requirements. (Insurer may present proof of like deposit in another state.)
Mississippi	$400,000	$600,000 Subject to RBC	$100,000	$50,000 (or a certificate from domicile state that it has deposited like amount there)
Missouri	Stock insurer $600,000	Stock insurer $600,000 Mutual $1,600,000 Subject to RBC	$600,000	$600,000
Montana	$200,000 for insurers licensed prior to Oct 1, 1999 $600,000 for insurers licensed after Sep 30, 1999	[$600,000?] Subject to RBC	Securities and assets in an amount not less than the reserves on outstanding life insurance policies and annuity contracts less policy loans, but may credit amounts otherwise held for policyholder protection.	Securities and assets in an amount not less than the reserves on outstanding life insurance policies and annuity contracts less policy loans, but may credit amounts otherwise held for policyholder protection. (Insurer may present a certificate that a like deposits is being maintained in another state.)
Nebraska	$2,000,000	$1,000,000 Subject to RBC	$100,000	$100,000 (Insurer shall deposit securities in amount not less than $100,000 with Nebraska or another state.)
Nevada	Paid-in capital or basic surplus $500,000	Initial free surplus $1,000,000 Subject to RBC	Stock insurer Minimum required capital stock (=$500,000) Mutual insurer Minimum required basic surplus (=$500,000)	Minimum required capital stock or basic surplus (Insurer may present certificate that deposit of like quality and amount is maintained in another state.)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
New Hampshire	Stock insurers $600,000 capital $150,000 paid-in capital Mutual insurers $500,000 capital	Stock insurers $750,000 Mutual insurers $800,000 Subject to RBC	Stock insurer $300,000 Mutual insurer $200,000 At commissioner's discretion, insurer may be required to deposit up to $1 million to protect policyholders.	No deposit requirements specifically for foreign insurers.
New Jersey	Stock insurer $1,000,000	Stock insurer $4,000,000 Mutual insurers $4,000,000 Subject to RBC	$100,000. Commissioner may require additional amounts up to sum of $250,000.	$100,000
New Mexico	$600,000	$400,000 Aggregate requirements relate to premium volume (earned or received): $700,000 (premium > $5 m) $800,000 (premium < $25 m) $900,000 (premium > $25 m) Subject to RBC	$100,000	$100,000 (Superintendent shall accept certificate from another state indicating that like deposit maintained there)
New York	$2,000,000	$4,000,000 Subject to RBC	$200,000 ($100,000 for insurers licensed before 7/1/82)	$200,000 (Superintendent shall accept certificate from another state indicating that like deposit maintained there)
North Carolina	Stock insurer $600,000 paid-in capital	Stock insurer $900,000 initial $150,000 maintenance Mutual insurer $200,000 initial $100,000 maintenance Subject to RBC	Stock insurer shall deposit required statutory capital. Mutual insurer shall deposit at least 50% of minimum required surplus.	$100,000 Additional $100,000 if it cannot show three years net operational gains prior to admission.

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
North Dakota	Stock insurer $500,000	Stock insurer $500,000 Mutual insurer $1,000,000 Subject to RBC	Securities equal to the net value of all the policies the company has in force.	No deposit requirements specifically for foreign insurers.
Ohio	Stock insurer Total maintained capital and surplus $2,500,000 with at least $1,000,000 each in capital and contributed surplus Mutual insurer $2,500,000 surplus	Subject to RBC	$100,000	$100,000
Oklahoma	Capital and surplus $500,000	Additional expendable surplus 50% of min. surplus Subject to RBC	$300,000 Commissioner may require a greater amount if warranted	$300,000 (Commission may accept certificate that like deposit being maintained in another state for insurers incorporated before effective date)
Oregon	Capital and surplus $1,000,000 $2,500,000 eff. Jan 1, 2002 Additional for domestic insurer when first authorised: $500,000	An insurer authorised to do business on Jan 1, 2002 shall possess and maintain at least the following amounts: $1.3 m no later than Dec 31, 2002 $1.6 m no later than Dec 31, 2003 $1.9 m no later than Dec 31, 2004 $2.2 m no later than Dec 31, 2005 $2.5 m no later than Dec 31, 2006 Subject to RBC	If assets deposited subject to material fluctuations in market value, director may require the deposit of additional assets.	[Same as for domestic insurers?]

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Pennsylvania	Stock insurer $1,000,000 Mutual insurer $2,000,000 guarantee capital	Stock insurer $500,000 Mutual insurer Unimpaired p/h surplus of $1,000,000 out of guarantee capital, surplus, or any combination thereof Subject to RBC	[No requirement?]	[No requirement?]
Puerto Rico	$500,000	$250,000 (50% of capital)	[?]	[?]
Rhode Island	Stock insurer $1,000,000	Stock insurer $2,000,000 Mutual insurer $3,000,000 Subject to RBC	Not applicable.	$100,000 (at state of domicile and providing a certificate to the commissioner)
South Carolina	Stock insurer $600,000	Stock insurer $600,000 initial $150,000 maintenance Mutual insurer $1,200,000 initial $750,000 maintenance Subject to RBC	Not less than $10,000 nor more than $200,000, as determined by director. Director may require greater amount. If a stock insurer has at least $10 million in capital and surplus and at least $1 million in acceptable securities with another state, the director may accept a certification of deposit from that state instead of requiring a deposit.	[Same as for domestic insurers?]
South Dakota	Domestic $200,000 Foreign $300,000	Domestic $300,000 Foreign $350,000 Subject to RBC	$200,000 Life insurers shall deposit an amount not less than required reserves on outstanding policies.	[$200,000?] (Director shall accept certificate from another state that like deposit being maintained there)
Tennessee	$1,000,000	$1,000,000 Subject to RBC	$200,000	$200,000 (in Tennessee or another state)

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Texas	$700,000	$700,000 Subject to RBC	Life, health, and accident insurers may deposit securities in which capital stock is invested or securities equal in amount to capital stock. Life insurer may deposit securities in which it is permitted to invest or loan its capital, surplus, or reserves equal to legal reserves on all outstanding policies in force.	No deposit requirements specifically for foreign insurers (certificate required if deposits elsewhere)
Utah	Stock insurer $400,000 Capital Mutual insurer $400,000 Surplus	Compulsory surplus: the greater of: 75% min capital net total of the following: $0.50 per $1,000 life insurance amount at risk + 10% disability premiums earned + 3.5% annuity reserves + 5% admitted value of common stocks and real estate + 2% admitted value of all other invested assets (some exclusions apply) – any mandatory security valuation reserve being maintained – minimum required capital Subject to RBC	Stock insurer Required capital (=$400,000) Mutual insurer Minimum permanent surplus (=$400,000)	Stock insurer Required capital (may be maintained in another state) Mutual insurer Minimum permanent surplus (may be maintained in another state)
Vermont	Commencing business after July 1, 1991 $2,000,000 Prior to July 1, 1991 $250,000	Commencing business after July 1, 1991 $3,000,000 Prior to July 1, 1991 $150,000 Subject to RBC	No provision.	
Virgin Islands	$100,000	$50,000	[?]	[?]
Virginia	$1,000,000	$3,000,000 Subject to RBC	$50,000 to $500,000 Additional reasonable amounts may be required	Same as for domestic insurers

State	Capitalisation	Solvency Requirements	Deposit Requirements for Domestic Insurers	Deposit Requirements for Foreign Insurers
Washington	$2,000,000	$2,000,000 Subject to RBC	Securities or funds in amount required as prerequisite to certificate of authority	Securities or funds in amount required as prerequisite to certificate of authority. (Commissioner may accept certificate from another state to the effect that like deposit is held there)
West Virginia	Stock insurer $1,000,000	Stock insurer $1,000,000 Mutual surplus $2,000,000 Subject to RBC	$100,000	$100,000 (Commissioner may accept certificate from another state to the effect that like deposit is held there)
Wisconsin	$2,000,000	$1,000,000 (50% of minimum capital) Subject to RBC	All funds received by stock insurers for stock subscriptions or by mutual insurers for applications or for mutual bond or contribution note subscriptions shall be deposited subject to escrow agreement.	No deposit requirements specifically for foreign insurers
Wyoming	$1,000,000	Stock insurer surplus $500,000 Mutual surplus $1,500,000 Subject to RBC	$200,000	Same as for domestic insurers. (Commissioner may accept certificate from another state to the effect that like deposit is held there)

C Exchange rates

1 As at 31 October 2002, the exchange rate of US$1, was

- Australia : A$1.80668
- China : RMB8.2872
- European Union : €1.01605
- Hong Kong : HK$7.7992
- India : Rs48.305
- Indonesia : Rph9,074.7
- Japan : ¥122.9
- Malaysia : RM3.7982
- Philippines : ₱53.225
- Singapore : S$1.771
- South Korea : KRW1,230.5
- Taiwan : NT$34.77
- Thailand : Bt43.336

Source: www.oanda.com

D Modelling assumptions

Product portfolio

1 Our financial models use various combinations of the following five products to represent different product models:

- Participating Whole of Life
- Non-participating Whole of Life
- Personal Accident
- Investment Linked
- Generic riders

2 The way in which each of these products is modelled is described below:

Non-Participating Whole of Life

3 Non-participating level premium whole of life plan which provides both life and dread disease cover. The design of this plan is based on our understanding of the regulations issued by the CIRC in June 1999, using a pricing interest rate of 2.5% and the specified loadings as shown below:

Policy Year	Premium Payment Term					
	1	5	10	15	20	30
1	10%	33%	55%	60%	65%	65%
2	0%	14%	20%	30%	40%	40%
3	0%	12%	15%	20%	25%	30%
4	0%	12%	15%	20%	25%	30%
5	0%	12%	15%	20%	25%	30%
6	0%	10%	10%	10%	10%	10%
7	0%	10%	10%	10%	10%	10%
8	0%	10%	10%	10%	10%	10%
9	0%	10%	10%	10%	10%	10%
10	0%	10%	10%	10%	10%	10%

4 These loadings have been chosen so that the policy year loading and the average loading for the policy do not exceed the limits specified by CIRC regulations shown below:

Policy Year	Gross Maximum Premium Loading					
	Premium Paying Term < 10 Years		Premium Paying Term from 10 Years to 19 Years		Premium Paying Term ≥ 20 Years	
	Death and Health	Annuity and Endowment	Death and Health	Annuity and Endowment	Death and Health	Annuity and Endowment
1	60%	35%	70%	45%	75%	50%
2	35%	20%	40%	25%	45%	25%
3	35%	20%	40%	25%	45%	25%
Thereafter	25%	15%	30%	15%	30%	15%

Premium Payment Matter	Average Policy Loading	
	Annuity and Endowment	Death and Health
Non-single premium	18%	35%
Single premium	10%	20%

Participating Whole of Life

5 Participating level premium whole of life plan which provides both life and dread disease cover. In addition a survival benefit of 8% of the sum insured is paid every three years. An annual dividend paid in cash every three years based on the mortality and interest profit of the company. This has been modelled according to one of the best selling participating products in China

Personal Accident

6 A yearly renewable term contract with a level premium, which provides benefits on accidental death and disablement, and also covers hospitalisation treatment within 180 days.

Investment linked

7 A level premium investment linked plan which has been modelled on one of the best selling investment linked products in China. The product provides both life cover and a maturity benefit. The benefits include:

- Death/Disablement
  - Greater of sum insured and unit value.
- Maturity benefit

  - Unit value
  - Maturity bonus
- Management fee
  - 1.2% p.a. of fund under management paid monthly
- Allocation rates of
  - 0% in year 1
  - 20% in year 2
  - 88% in year 3 and subsequent
- Bid/offer spread
  - 5% bid offer spread

Generic Rider

8 A rider benefit has been included to represent a generic hospitalisation or premium waiver product which is common in the China market. This rider is assumed to be attached to each of the plans mentioned above.

Commission and commission override costs

9 The commission levels are modelled explicitly, and comply with the maximum levels specified under the regulations in China. The rates used are those commonly used in the market place and for the traditional and investment linked business range from 35% in the first year and reduces to 5% in the 5th year.

10 The commission override costs follow our understanding of the levels paid in China.

Actuarial and other assumptions

11 The major actuarial assumptions incorporated in our model include:

- Investment return between 4% to 4.5% per annum net of investment expenses and business tax for the assets backing the participating and non participating policies, riders and capital. For the investment linked policies, the return is around 1% higher.
- A corporate tax rate of 33% of taxable income is assumed, and in deriving the taxable income we assume that a proportion of the investment return is derived from government bonds which is tax free. Tax losses are assumed to be carried forward for 5 years.
- Business tax as a percentage of premium is deducted from short term business premium income.

- Expenses are projected based on a "bottom-up" expense model that identifies the main component of cost. The expense model varies in line with the distribution strategy.
- The mortality table is based on the China CL1 non-annuity with a 2 year select period. For critical illness the pricing incidence rates have been used.
- The discontinuance rates are those which we understand are currently being experienced in the market and are in the range of 20% in year 1 reducing to an ultimate rate of 7.5%.
- The bonus distribution for the participating plan is 70% of the mortality and interest profit to the policyholder and 30% to the company.
- The reserving follows the CIRC valuation methods, being
  - For the non participating business, the reserving method is a "Full Preliminary Term" on the basis of 2.5% interest and 100% of China CL1 non-annuity Mortality table (based on 1990-1993 experience).
  - For the participating business, the reserving is as above except the valuation interest rate is 2.0%.
  - For the personal accident and generic rider an unearned gross premium method is used.
  - For the investment linked plans the account balance is used, together with a "sterling reserve" for future strain resulting from expenses and maturity bonus.
- The surrender value method follows the CIRC calculation method.
  - For the non participating contract, this is 4.5% interest, China CL1 non-annuity mortality table, original pricing loading.
  - For the participating contract the reserving is the same as above except the interest rate is 4%.
  - For the investment linked plans the surrender value is the account balance.
  - There is no surrender value for the personal accident or generic rider.

PREPARED STATEMENT OF DARYL HATANO

SEPTEMBER 24, 2003

Chairman Leach, Chairman Hagel, distinguished Commission members, the Semiconductor Industry Association (SIA) is pleased to testify today regarding China's compliance with its WTO commitments. The SIA represents the $70 billion U.S. semiconductor industry. U.S. semiconductor firms are leading global competitors, commanding 50 percent of world market share.

China represents a large and growing market for semiconductors and other information technology products. In fact, semiconductors are the second largest U.S. export to China. Over the past decade, SIA was a strong supporter of legislation to provide Permanent Normal Trade Relations with China as part of China's entry into the WTO, and SIA is pleased that the Chinese government has taken a number of positive steps in implementing its WTO obligations. However, several areas will require continued efforts by the Chinese government in order to fulfill the commitments made under WTO accession. My comments today will only elaborate on those issues of special relevance to American semiconductor producers, including China's value added tax rebates for domestically produced chips, semiconductor intellectual property, transparency, and local content.

CHINA MARKET

In 2001 the Asia Pacific region, driven primarily by growth in China, surpassed the U.S. as the largest semiconductor market in the world. In terms of demand, in 1997, the U.S. represented 33 percent of the world market, while the Asia Pacific region represented 22 percent. Five years later, in 2002, the Asia Pacific share had grown to 36 percent, compared to the U.S. share of 22 percent—a reversal of positions. By 2005, the U.S. is projected to be the smallest of the four regional markets,[1] representing only 18 percent of the world, less than half of the 40 percent share that the Asia Pacific market is projected to represent. The growth of the Asia Pacific market has been driven by the growth in China. China's $18 billion integrated circuit market represented 15 percent of total world demand in 2002, up from 7 percent of the world in 2000.

China's semiconductor market growth is occurring within the context of significant growth in China's computer and telecommunications markets. China is now the world's largest mobile phone market, and second largest personal computer market.

Currently domestic Chinese production, including foreign owned facilities in China, meets only about 15 to 20 percent of its market demand, with the remaining 80 to 85 percent met by imports. The Chinese government's Tenth Five Year Plan, covering 2001–2005, has an ambitious target to ensure that by 2005 "60 percent of IT products should be home grown," and that China shall "gradually design and develop its own IC products, (including [central processing units])."

SIA'S EFFORTS IN CHINA

SIA has been encouraging an open trade environment in China for over a decade. SIA has sent delegations to China since the early 1990s to meet directly with Chinese government and industry officials to discuss the benefits of market liberalization to China's economic growth and to U.S.-China relations. SIA provided advice to the U.S. Government on the WTO accession issues of importance to the semiconductor industry and, as noted earlier, was an active supporter of legislation to allow Permanent Normal Trade Relations with China.

Based on SIA's interactions with senior Chinese government officials, we believe that there is a genuine commitment expressed by all Chinese officials to full and faithful execution of China's WTO obligations.

SIA was pleased that China became a signatory of the WTO's Information Technology Agreement (ITA) in April 2003, committing to eliminate tariffs on a range of information technology products. SIA has long supported the elimination of semiconductor tariffs, beginning with the suspension of U.S. tariffs in 1985, because tariffs increase costs to consumers and thus impede the ability of consumers to take advantage of semiconductor technology. SIA was an early supporter of the ITA, and China's joining this agreement was a high priority because of the consumer benefits that would flow from the elimination of tariffs on semiconductors, computers, telecommunications equipment, and semiconductor manufacturing equipment. The elimination of China's 6 to 12 percent semiconductor tariffs in January 2002, con-

[1] The four regions are North America (primarily the United States), Europe, Japan, and Asia Pacific.

tributed to a reduction in smuggling and resulting shift to legitimate import channels, better positioning U.S. companies to take advantage of trading rights when they are fully phased in at the end of 2004 (3 years after accession). SIA was pleased that China was able to resolve the "end use" certification issue that had initially prevented its formal participation in the ITA. China had imposed "end use" certification requirements on 15 ITA products, that were inconsistent with the ITA, and would have created a dangerous precedent, especially as we sought to expand the ITA to additional countries. SIA is pleased that China is now a full participant in the ITA, and we appreciate the efforts of USTR that led to this result.

VALUE-ADDED TAX

China imposes a value-added tax (VAT) of 17 percent on sales of all imported and domestically produced semiconductors and integrated circuits. However, current Chinese government policy provides for a rebate of the amount of the VAT burden in excess of 6 percent for integrated circuits manufactured within China (and the amount of the VAT burden in excess of 3 percent for integrated circuit designs developed in China).[2] This discrimination against imported semiconductors through the VAT rebate is inconsistent with China's WTO obligations.

Reduction of the semiconductor VAT should apply to all semiconductors and integrated circuits sold in China (whether domestically produced or imported). Application of the VAT reduction to all companies would allow China to come into compliance with its WTO obligations to refrain from discrimination against imports while maintaining its commitments to investors in domestic facilities of a reduced VAT rate.

GATT Article III (on "National Treatment") establishes a general prohibition against a WTO member engaging in activity that discriminates in favor of domestic products at the expense of imported products. Specifically, paragraph 2 of this article states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. By rebating the amount of the VAT burden over 3 percent or 6 percent for local products, while continuing to impose the full 17 percent VAT on imported semiconductors, the current policy violates this basic GATT/WTO obligation.

Prior GATT decisions clearly establish that it is a violation of the national treatment principle to grant a tax credit or rebate to certain domestic manufacturers of a product while charging the full tax rate to similar foreign-manufactured products. This is true even if the tax credit or rebate is intended to provide a subsidy to local producers. While China does provide the benefits to both domestic and foreign-owned facilities in China, the different treatment of domestic and imported products is a violation of its national treatment commitment. Any tax imposed on imported goods must be collected in a non-discriminatory manner.

The best solution for U.S. export interests and the development of China's information technology market is for the PRC to reduce or eliminate the VAT rate for all semiconductors and integrated circuits, regardless of origin.

As noted above, China joined the Information Technology Agreement (ITA) and has eliminated all tariffs on semiconductors in 2002 and will eliminate tariffs on other information technology products in the near future. The same public policy reasons that caused China to decide to eliminate its tariffs on semiconductors apply with equal force to a decision to lower the VAT rate. A substantial portion of the growth of the American economy has been attributed to information technology and the productivity enhancements made possible by advances in semiconductor technology and production. Just as it was in China's interest to eliminate all import tariffs on semiconductors, significant reduction in the VAT rate imposed on all semiconductors would contribute to the growth of the Chinese IT market and would benefit the Chinese economy in general. In addition, reports indicate that China's elimination of semiconductor tariffs (formerly 6–12 percent) has succeeded in reducing smuggling of semiconductors into China. As the high VAT rate on semiconductors provides an incentive for smuggling, this runs counter to the high priority the Chinese government has placed on eliminating illegal entry of goods.

Although it is not designed to do so, the high VAT rate imposed on semiconductors imposes significant costs on Chinese electronics producers on exports from China. While China ostensibly rebates the VAT on semiconductors and other electronics components when the finished product containing the inputs is exported, many exporters from China have been unable to receive the full amount of the rebate officially due to them because provincial and local authorities may refuse to rebate VAT charges collected by another jurisdiction within China.

[2] State Council Document Number 18, June 2000.

There have been several noteworthy developments on the VAT rebate issue this year. First, there is the growing recognition in Washington as well as in other world capitals that China's VAT rebate program is a violation of the WTO. In March, 32 Members of the U.S. House of Representatives sent a letter to Ambassador Zoellick stating "We believe China should eliminate the VAT for all semiconductors regardless of origin and we encourage you to continue to press for a speedy resolution of this violation." In June, 21 U.S. Senators sent Ambassador Zoellick a letter stating "We urge you to continue to vigorously insist that China lower its VAT on semiconductor imports to abide by its World Trade Organization (WTO) commitments . . ." Many of you on the Commission signed these letters, and we appreciate the continued support of Congress on this issue.

In May, the World Semiconductor Council (WSC) issued a joint statement critical of China's VAT rebate program. The WSC is composed of CEOs from companies representing the European Semiconductor Industry Association (EECA–ESIA), Japan Electronics and Information Technology Industries Association (JEITA), Korea Semiconductor Industry Association (KSIA), Semiconductor Industry Association (SIA), and Taiwan Semiconductor Industry Association (TSIA). The WSC stated:

> ". . . under China's current application of its Value Added Tax (VAT), a VAT of 17 percent is applied to all semiconductors, but companies designing and manufacturing semiconductors in China are eligible to receive a substantial rebate of the VAT paid on those semiconductors. This reduces the effective VAT burden on domestically designed and produced semiconductors to only 3 percent. Discrimination has the effect of limiting market access, distorting patterns of trade and investment, and negates the benefits China promised to provide when it joined the WTO. The WSC calls for China to lower its VAT rate to 3 percent for all semiconductors, regardless of origin."

A second key development is USTR's formal inquiries to the Chinese on this subject. Coupled with the interest on Capitol Hill and the WSC, USTR's request that China address the VAT rebate problem has attracted the attention of Chinese government officials. As a result of this attention, China has formed a research group to re-examine the VAT issue. In SIA's recent meetings in China, we sensed a willingness in some quarters to explore alternatives with the U.S., but in other quarters, continued skepticism that changes were necessary. The U.S. government must continue to insist that China quickly come into compliance with GATT article III.

Lowering the VAT for both domestically produced and imported semiconductors would be a non-discriminatory policy that is in China's interest for all the reasons set forth above. Non-discriminatory application of the VAT rebate for all semiconductors would allow Chinese electronics producers to obtain the most advanced technology available worldwide at the most competitive prices, benefiting Chinese consumers and the entire Chinese economy, as well as encouraging growth in China's IT sector.

INTELLECTUAL PROPERTY PROTECTION

SIA would like to underscore the importance of China's full compliance with its commitments to improve intellectual property (IP) protection. This is critical not only to U.S. firms doing business in China, but also in China's self interest, as it will encourage the high technology foreign investment China seeks in order to promote the development of its economy while simultaneously encouraging local entrepreneurs to engage in innovation.

Before discussing the issue of enforcement, let me begin by congratulating China for its success in resolving one issue related to its semiconductor layout design protection law. In March 2001, China's State Council passed Regulation on Integrated Circuit Layout Design Protection, which took effect October 1, 2001. Last year, a senior official of the Ministry of Information Industry made comments indicating that China's new law did not cover discrete semiconductors. SIA objected to this interpretation because the WTO TRIPs agreement is clear that discretes, which are products with only one active element, are to be protected. We are pleased to report that, in a response to a question posed by the United States, China affirmed before the Council for Trade-Related Aspects of Intellectual Property Rights that "With respect to discrete mentioned in the question in particular, if it complies with provisions of Article 2 and Article 4 of the Regulations on the Protection of Layout Designs of Integrated Circuits, it can be protected through applying for registration of layout-design."[3] We believe that this resolves the discretes issue, and again express

[3] Council for Trade-Related Aspects of Intellectual Property Rights; Responses from China to the Questions posed by Australia, the European Communities and their member States, Japan and the United States; IP/C/W/374 10 September 2002; Page 43.

our appreciation the USTR and Chinese government for their efforts to bring this question to a satisfactory conclusion.

SIA would like to highlight the need for strengthened IP enforcement. IP protection is important not only in China, but in all markets around the globe. The World Semiconductor Joint 2003 Statement, referenced above, emphasized the need for strong intellectual property protection around the world, stating:

> "Semiconductor makers must invest a very high percentage of sales in R&D, and the intellectual property that results is the lifeblood of the company. Failure to adequately protect intellectual property is very damaging to the semiconductor industry. There are an increasing number of instances of counterfeiting of IC's and other semiconductors. One form of counterfeiting is the unauthorized direct optical copying of the chip, and reproduction of a mask work (layout design/topography) based on the optical copying, and then fabrication of a semiconductor based on this mask work and sale under a different company's name. Another form of counterfeiting involves reverse engineering a company's chip, and then producing a physically identical chip and selling it without authorization under the original company's name and trademark. Both types of counterfeiting must be quickly addressed and stopped."

The World Semiconductor Council is now working on a proposal to establish fast track consultative mechanisms to encourage enforcement actions to counter IP violations, and to encourage manufacturers to develop policies to prevent their inadvertently making semiconductors that violate a third party's IP. We are hopeful that this proposal will be adopted in all semiconductor producing regions around the world.

SIA is aware of numerous reports of IP violations in China. In one typical case, an SIA member company found that Chinese firms were making identical copies of its chips and data sheets, and selling it under the Chinese company's name. Under TRIPs, reverse engineering a chip to design an original and better product is allowed under the layout design laws. However in this case the chips were essentially photocopies of the U.S. design, which we know because the pirate included the U.S. company's part number etched in a submask level and unused circuits that the U.S. firm had placed on the chip to reserve space for future product development. The Chinese firms that engage in piracy are typically thinly capitalized companies that contract the manufacture of the copied chips to foundries that can afford to make the necessary capital expenditures.

China's court system is still developing, and U.S. firms are concerned about the fairness of its procedures. For example, we understand that only "legitimate" purchases are actionable. These rules put an unreasonable burden on U.S. firms who cannot hire a private investigator to purchase the counterfeits, but must instead find purchasers of the counterfeit product and convince those purchases to sign a statement that they bought the counterfeit goods. China also has administrative enforcement mechanisms, but these are largely untested.

In the aforementioned letter signed by 32 House members, the Representatives stressed that "the improved laws China put in place to protect IP are useless unless they are supported by transparent, standardized and predictable court procedures that make the judicial system accessible . . . We must continue to demand that China immediately upgrade its IP enforcement mechanisms so that foreign semiconductor companies have certainty their products are protected in this emerging market." The letter signed by 21 Senators to Ambassador Zoellick stated "We encourage you to continue to press for strengthened enforcement to bolster the credibility of [the IP] laws, and to explore with your Chinese counterparts alternative solutions such as fast track investigations of alleged piracy." Given its importance to both U.S. producers and China's economic development, SIA urges USTR and the Chinese government to continue to make IP enforcement a high priority issue.

TRANSPARENCY

Several commitments in the final protocol of accession are expected to improve transparency in China's administrative rulemaking. For example, China has agreed that only those trade-related measures that are published and readily available will be enforced. China has also agreed to make information on trade-related measures available to WTO members upon request before those measures are implemented or enforced.

Additionally, China has committed to establish or designate an official journal for the publication of all trade-related measures and to provide a reasonable period of time for comment to the appropriate authorities before measures are implemented. China is considering providing this information in English in order to provide transparency to the international business community, and to post the information on the

web. These are important steps in improving transparency. SIA urges China to fully implement these measures.

LOCALIZATION

There had been localization requirements for parts and materials for products made in China which, while not technically legal requirements, imposed serious restrictions on firms' ability to utilize imported parts. Firms had been required to file localization plans with their foreign investment application. The Chinese government also audited foreign firms to determine local content. What constitutes local content can be subject to many definitions. For example, importation via a Chinese distributor can qualify a part as "local." Chinese sectoral industrial policies also contain local content requirements. Prior to its accession to the WTO, China had imposed local content requirements on products containing semiconductors.

In our discussions with Chinese officials, there was a recognition that these policies are inconsistent with China's WTO obligations and would be repealed in time. SIA again calls for the immediate repeal of all local content policies as required by the terms of the WTO accession agreement.

During the China WTO accession negotiations, the Chinese government confirmed that China would ensure that all state-owned and state-invested enterprises would make purchases and sales solely on commercial considerations, e.g. price, quality, marketability, availability, and that the enterprises of other WTO members would have an adequate opportunity to compete for sales to these enterprises on a nondiscriminatory basis. In addition, the Chinese government committed that it would not influence commercial decisions on the part of state-owned or state-invested enterprises. Adherence to these commitments will be critical for China's development because it will ensure that Chinese electronics firms are able to purchase the most competitive chips free from political interference. Given the market access problems that the U.S. historically faced in other semiconductor markets, it is also critical to U.S. export interests that China's state-invested enterprises purchase solely on a commercial basis.

CONCLUSION

China is a large and fast growing market. The economics of our industry dictate that U.S. firms, to remain competitive, must be able to compete on a fair and open basis for sales in China. For this reason, we are very encouraged by China's efforts to implement its WTO commitments, but we are concerned over the remaining existence of barriers and impediments to trade in China. While the challenge of promoting economic development in a country the size of China is immense, we are encouraged by China's progress and are hopeful that China will lower its VAT for all semiconductors, vigorously enforce its IP laws, eliminate its local content requirements, and improve transparency.

SIA thanks the Commission for the opportunity to testify today. We look forward to continuing to work with the U.S. Government on these important issues.

PREPARED STATEMENT OF WILLIAM PRIMOSCH

SEPTEMBER 24, 2003

Mr. Chairman and Members of the Congressional-Executive Commission, Thank you for giving the National Association of Manufacturers (the NAM) to testify on a subject of great interest to U.S. manufacturers.

The NAM represents 14,000 manufacturing companies, both large multinational corporations and over 10,000 small and medium-size firms. I can tell that we hear more from our members about trade with China than with any other foreign country.

Trade with China is of immense importance for U.S. manufacturers both because China's growing economy of 1.2 billion consumers offers a major market for U.S. products and because China is also an increasingly vigorous competitor in the U.S. and global marketplace.

The Chinese market is set to become one of the largest in the world within the next several years. Chinese imports are expected to exceed $380 billion in 2003, making China the world's third largest importer after the United States and Germany. At the same time, China is rapidly becoming a major exporter of industrial goods, and the range of industrial products exported has continued to grow at a rapid pace. China's expanded participation in the global marketplace, then, offers both new commercial opportunities as well as challenges resulting from increased competition in the U.S. and foreign markets.

Many NAM members, notably large multinational corporations, have developed important commercial relationships in China and seek to expand their share of the Chinese market. At the same time, a large number of members, particularly small companies, have expressed concern about increased import competition from China in the United States and currency and trade practices that give Chinese producers an unfair advantage.

In several meetings on China over the past year, our members have told us that they want the United States to have a positive trade relationship with China. However, they also want a level playing field for competition. Manufacturers want the U.S. Government to deal firmly with unfair Chinese trade and currency practice. And they want the U.S. government to advance the long-term goal of providing U.S. companies with the same kind of access for U.S. goods and services in the Chinese market that Chinese goods and services enjoy in the U.S. market.

U.S. manufacturers view China's membership in the WTO, which became effective in December 2001, as an important positive development. As a WTO member, China has now committed to abide by the same international trade rules that apply to the United States and most other countries. In addition, it has made significant commitments to open its internal market to foreign products and services in areas where the United States is highly competitive. The NAM supported China's membership and Permanent Normal Trade Relations (PNTR) status on the condition that China would adhere to these commitments and become a responsible participant in the international trading system.

As China concludes its second year as a WTO member, its compliance record is decidedly mixed. While U.S. exports to China continue to increase (by 24 percent in January–June 2003) and a growing number of U.S. companies are trading and investing there, the NAM has also received far more complaints about unfair Chinese practices than in the previous year.

NAM members recognize that China is still in transition to a market economy and in the process of phasing in certain WTO market-opening commitments. However, because China has quickly become such an important global importer and exporter, it is vital that the United States work to ensure that China complies with all WTO obligations and particularly those that have a significant impact on U.S. economic interests.

CHINESE POLICIES THAT PROVIDE UNFAIR ADVANTAGES AND CREATE NONTARIFF BARRIERS

In a recent survey, our members identified a variety of policies that have provided Chinese exporters with unfair trade advantages and created significant nontariff barriers that hinder market access for U.S. products in China. In the view of many manufacturers, China's undervalued currency is the single most important factor because it affects all Chinese exports and imports. Other policies also serve to limit U.S. exports to China and give Chinese products in the United States a competitive advantage. Taken together, these policies are making a significant contribution to the U.S.-China trade imbalance, which was $103 billion in 2002 and could reach $130 billion in 2003. The following section provides more details on individual issues of concern.

CURRENCY MANIPULATION

By far, the NAM has received the greatest number of complaints about China's deliberate policy of undervaluing its currency to gain unfair competitive advantage over U.S. producers and those of other WTO member countries. Economists have estimated that China's currency could be undervalued by 40 percent or more. The Chinese yuan has remained pegged to the dollar at 8.28 for the past 8 years despite an extended period of robust economic growth, continuing trade surpluses and a large buildup in foreign exchange reserves, which exceeded $350 billion in July 2003. This level of foreign exchange reserves is, according to IMF analysis, far in excess of what would be required to cushion China's balance of payments from normal fluctuations in trade and investment flows.

Pegging the yuan to the dollar appears to be part of a deliberate strategy to support Chinese industry and boost exports. This kind of currency undervaluation for commercial gain goes against the intent of the General Agreement on Tariffs and Trade (GATT), which seeks to remove trade barriers and allow markets to determine trade flows. Article IV, for example, states that "Contracting Parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement . . ." China's undervalued currency acts as an additional trade barrier to U.S. exports and an unfair subsidy for all Chinese exports. We believe that Chinese exchange rate policies are not in accord with WTO obligations.

The NAM appreciates efforts by the Bush Administration, particularly Treasury Secretary John Snow, to raise the importance of market-based exchange rates with Chinese leaders and obtain unprecedented support from other finance ministers in the G–7 and APEC. We are confident that a more flexible market-based exchange rate would result in a significant appreciation of the yuan against the dollar and help to level the playing field with Chinese producers both here at home and in the global marketplace. We strongly urge the Administration to continue to press the Chinese government to break the current peg and allow the yuan to move up to its true market value.

SUBSIDIZED EXPORTS

We continue to receive reports from different industries (e.g., tool-and-die, metal forming, steel and chlorinated isocyanurates) that Chinese products are being sold in the United States at prices so low that they could not even cover the cost of raw materials and shipping much less full production and marketing costs. A tool-and-dye company, for example, reports that a Chinese competitor was selling a product similar to one made in the United States for $40,000, compared to the U.S. producer's price of $100,000. The U.S. company maintains that the cost of the raw materials alone would amount to $40,000, not including shipping, duties and other costs. A U.S. producer of chlorinated isocyanurates, which is used as a cleaning agent in swimming pools, reports a similar situation. As a result of pricing which appears to be below cost, Chinese exporters are expected to increase exports of this product by 400 percent in 2003 over 2002 levels.

These reports suggest the possibility of widespread use of subsidies, either direct or indirect, to help Chinese exporters gain unfair competitive advantage in the U.S. market. They merit further investigation by USTR and the Department of Commerce. One source of indirect subsidy is continued bank lending to money-losing and insolvent Chinese manufacturers, often state-owned or state-controlled enterprises. Since the Chinese banks providing these loans are either state-owned or state-controlled, the Chinese government bears responsibility for their lending practices. U.S. steel producers note that the Chinese steel industry is the largest recipient of interest rate subsidies authorized by the national government. Since many of the companies that benefit from either directed bank lending or subsidized interest rates are engaged in international trade, they have an unfair competitive advantage vis-à-vis U.S. based companies, which must rely on private financing at market rates.

COUNTERFEITING AND INEFFECTIVE ENFORCEMENT OF IPR PROTECTION

While Chinese laws on intellectual property rights (IPR) have improved considerably, the lack of effective enforcement of the IPR protection remains a serious problem. Violations of trademarks through product counterfeiting is rampant and on a massive scale. The violations involve a wide range of products, including consumer hygiene and health care products, athletic footwear, pharmaceuticals, food and beverages, motorized vehicles and even entire automobiles. Pharmaceutical counterfeiting is now, according to U.S. industry representatives, a serious public health concern in China. We believe that the lack of criminal penalties for counterfeiting, including jailing, prevents effective enforcement of trademark and labeling violations.

We are also concerned about reports that local government authorities are actually promoting the expansion of local industry dedicated principally to counterfeiting. At a minimum, local authorities are knowledgeable of counterfeit production and taking no action to halt it. There appears to be no mechanism for the national government to prevent local governments from aiding and abetting counterfeiting by local industry. In addition, a member has reported that the Chinese customs service has not cooperated in blocking exports of counterfeit products even when solid evidence of counterfeiting was provided. It is claimed that, since the "exporting" of counterfeit products does not constitute a "sale" of the products, the relevant Chinese law did not apply.

Other IPR violations are also common. They include unauthorized duplication of computer software, music and films; copying of designs; unauthorized use of patented technology; and unauthorized use of U.S. product certification logos. The makers of air conditioning and refrigeration equipment note that the ARI (Air-Conditioning and Refrigeration Institute) certification symbol was being used without authorization by a Chinese company. Efforts to have the Chinese government stop this unauthorized use proved ineffective.

The pharmaceutical industry does, however, also report improvements in intellectual property protection, notably by the promulgation of a new regulation on data

exclusivity for clinical trials, as required in TRIPS and committed in China's accession package.

MANIPULATION OF VAT AND OTHER TAXES

We have reports that China is manipulating the application of taxes, notably the Value-Added Tax (VAT), to both restrict imports and indirectly subsidize exports. For example, the scrap recycling industry has told us that Chinese users of imported copper and other scrap metals are deliberating undervaluing their invoices to pay less VAT on the imported metal. When the finished metal products are exported, however, Chinese producers claim a rebate of the VAT based on the metals' real import price. This results in a substantial subsidy for the exported product that translates into lower prices in the U.S. market. It also enables Chinese scrap metal users to pay higher prices for scrap metal than their U.S. competitors. Chinese customs and tax authorities have not taken action to investigate these practices.

We are also concerned about continuing Chinese discrimination in the application of the VAT on imported and domestically produced semiconductors. China levies a 17 percent VAT on imported integrated circuits. Domestically designed and produced integrated circuits are taxed at VAT rates ranging from 3–6 percent. Integrated circuits produced in China but designed abroad are taxed at 11 percent. This discriminatory treatment of domestic and foreign "like" products violates Article 3 of the GATT.

UNJUSTIFIED LABELING REQUIREMENTS

In 2002 the Chinese Ministry of Health promulgated a new regulation mandating the labeling of all genetically modified (GM) food products. While the implementation of the regulation was subsequently suspended indefinitely, the fact that it remains on the books is already having significant adverse economic effects and creating barriers to trade. Some producers have ceased shipping these products in anticipation of the regulation going into effect.

U.S. food producers have questioned whether the Health Ministry's action was in conformity with China's WTO obligations. The ministry did not provide a justification for the labeling requirement based on an assessment of health risks, which is a requirement of the Agreement on Sanitary and Phytosanitary Measures. The Technical Barriers to Trade Agreement (TBT) also suggests inadequate attention to the treatment of "like products," the question of whether the labeling requirement addresses a "legitimate objective" and the requirement to base technical regulations on "performance" rather than "design" characteristics.

INAPPROPRIATE STANDARDS AND CONCERNS ABOUT CCC MARK SYSTEM

Several NAM members have raised concerns about application of technical standards and the CCC Mark system. With regard to standards, China is requiring that certain products (e.g., electrical products) be manufactured only to "international standards" as determined in the ISO or IEC. Other "international standards," notably those developed in the United States and widely used in the global marketplace, are not allowed. This does not conform with the WTO TBT Committee interpretation that "international standards" need not be limited to ISO or IEC standards.

A second set of standards concerns relates to the CCC mark system. China introduced the CCC mark system to comply with WTO requirements for a single mark for like domestic and imported products. It is, in that sense, a step forward on standards and mark requirements. However, the inconsistent, non-transparent and inflexible application of the CCC Mark on a variety of products (e.g., electrical products, air conditioning and refrigeration equipment, and tires) has created market access barriers and needlessly raised the cost of importing products into China.

Generic problems include: the high cost of having Chinese inspectors audit factories in the United States and other foreign countries on compliance with the standards; continued delays in allowing U.S. testing and certifying bodies to certify compliance for the CCC mark; and lengthy delays and relatively high cost of obtaining testing and certification for the CCC mark in China.

Several other specific problems were noted. A major tire company reported that several types of its bus tires that are standard sizes in countries around the world cannot obtain the required CCC mark because these sizes are not listed in the Chinese National Standards. Another type of tire used widely on Chinese trucks is also not on the list and thus cannot be sold by the U.S. company in China. Efforts to resolve this problem with Chinese standards authorities and Chinese customs have thus far been unsuccessful. In addition, the company reports that local inspection offices appear to be abusing their authority by requiring the re-inspection of the

company's Chinese-produced tires and confiscating tires which they determine to be "non-compliant" with the CCC mark standards.

RESTRICTIONS ON TRADE RIGHTS OF JOINT VENTURES

China is not fulfilling its commitment to allow foreign joint ventures to import and sell products (e.g., tires, automobiles, auto parts and industrial equipment) in China, which was to have gone into effect on Dec. 10, 2002. A major tire company, for example, reports that the Chinese government has imposed additional restrictions on its trading rights that were not anticipated when this concession was negotiated. They include allowing only new joint ventures to have this right and requiring the Chinese and foreign partners to have separately done U.S. $30 million in trade with China over each of the 3 preceding years.

LACK OF ACTION ON AUTO FINANCING REGULATIONS

The Chinese government has committed to publish new regulations governing the financing of automobile purchases. Several NAM member companies have expressed concern about slow progress on the regulations that were explicitly promised in China's accession agreement. The U.S. government should press for their prompt issuance to comply with WTO obligations.

LACK OF TRANSPARENCY IN TRADE REGULATORY PROCESS

Many companies complain about the lack of transparency in the trade regulatory process and the difficulty in obtaining current laws and regulations governing trade and business operations. This is a continuing problem that should lend itself to solutions in a relatively short time frame. The U.S. Government should press for concrete steps that improve transparency at all levels.

POLICY CHANGES NEEDED BY THE U.S. GOVERNMENT

U.S. agencies, particularly the Department of Commerce, Office of the U.S. Trade Representative and Treasury Department, have made good efforts to advance U.S. trade interests with China. Both Commerce and USTR are actively monitoring China's compliance with its commitments to abide by WTO rules and open its internal market in accordance with the provisions negotiated in the WTO membership agreement. They have welcomed input from the business community to assist in their analysis and assessments. The Treasury Department has also made important efforts to raise manufacturers' concerns about China's undervalued currency.

The scope of the challenges in China, however, requires a much larger-scale effort than currently exists, with additional resources to address unfair trade and currency practices and support effective promotion of U.S. exports. The NAM recommends the following policy actions to meet these challenges:

1. Seek full WTO Compliance.—The U.S. Government must ensure that China complies with its commitments as a new World Trade Organization member to follow all international trade rules and open its internal market in accordance with specific benchmarks set forth in its membership agreement. Commerce and USTR need additional resources to monitor and fully investigate WTO compliance concerns and market access problems. Current resources are inadequate to the task.
2. Stop Currency Undervaluation.—We must continue to press China to end the manipulation of its currency and allow the yuan/dollar exchange rate to be determined by the market forces. Secretary Snow's visit was an excellent start in raising the issues, but we need to keep the pressure on China and get other affected countries (e.g., our G–7 partners) to join us. The NAM is prepared to support a Section 301 trade complaint in concert with other members of the Sound Dollar Coalition as a way of underscoring the seriousness of the matter and the need for a credible Chinese response.
3. End Subsidized and Non-Market Production.—We hear too many reports from NAM members that Chinese imports are far below the cost of production based on international prices for raw material inputs. These charges merit more detailed investigation. In our dialog with China, we must insist that the prices of traded goods are determined by real economic costs and not costs artificially set by the government.
4. Address Counterfeiting and IPR Violations.—We must take firm actions to end China's rampant counterfeiting of U.S. and other foreign products. Today China is the epicenter of world counterfeiting, costing us tens of billions of dollars in lost exports and the related jobs. At both the national and local levels, the Chinese government is ignoring the blatant counterfeiting of U.S. products and taking no action to prevent this. The U.S. Government needs to engage in a frank dialog

with Chinese authorities on the need to address the problem of counterfeiting and other intellectual property rights violations and take action under U.S. trade law when problems are not resolved.

5. Expand Export Promotion to Support U.S. Business.—Finally, the United States needs to undertake a large-scale joint public-private export trade effort to increase U.S. exports to China. In 2003, China is set to become the world's 3rd largest importer ($380 billion) but the United States only has an 8 percent share of all Chinese imports. U.S. companies need to increase their marketing efforts but greatly expanded Commerce Department and other promotion assistance is also needed. We recommend a network of low-cost American business centers throughout China to help U.S. companies overcome the many unique barriers to doing business in China (e.g., language, cultural, communication and infrastructure) and access rapidly growing urban areas in the country's interior.

A balanced strategy that emphasizes stricter compliance with trade rules, an end to currency undervaluation and improved market access will not only help U.S. manufacturers compete on a level playing field but also place the U.S.-China trade relationship on a more stable footing for long-term development.

Thank you for giving the NAM the opportunity to testify today.

PREPARED STATEMENT OF LAWRENCE J. LAU

SEPTEMBER 24, 2003

Mr. Chairman, Mr. Co-Chairman, distinguished commissioners, ladies and gentlemen. It is a great honor for me to have the opportunity to testify before your Commission. As recommended by your Commission staff, I shall focus on the U.S.-China trade imbalance and whether the imbalance can be corrected by a revaluation of the Renminbi, the Chinese currency, vis-à-vis the U.S. Dollar.

The Chinese trade surplus in goods and services vis-à-vis the United States is large and growing. Official U.S. data overestimate the Chinese surplus and official Chinese data underestimate the Chinese surplus because of their different treatments of re-exports through Hong Kong and other trans-shipment points. Prof. K.C. Fung, of the University of California at Santa Cruz and I have adjusted the data of both countries and derived adjusted estimates of the U.S.-China trade imbalance. For 2002, our best estimate of the Chinese trade surplus for goods and services combined is US$74.3 billion (see Appendix Table 1).

However, despite the large Chinese trade surplus vis-à-vis the United States, the overall Chinese trade surplus with the World as a whole is relatively small, and has been becoming smaller, especially after Chinese accession to the World Trade Organization (WTO). It is projected to be approximately US$10 billion for 2003, or 1.5 percent of total Chinese international trade. This implies that China will have a trade deficit with the rest of the World, which is projected to be on the order of US$70 billion for 2003. The trade surplus vis-à-vis the United States is projected to be in the US$80 billion range.

In contrast, Japan has a large trade surplus both with the United States and the World as a whole. For 2002, Japan has a trade surplus of approximately US$62 billion with the United States and a trade surplus of approximately US$80 billion with the World as a whole. Its balance of payments, on a current-account basis, is thus much more out of equilibrium than China's.

Moreover, the Chinese exports to the United States have mostly originated from foreign- (including U.S.) invested enterprises in China or Chinese subcontractors to foreign firms and are the direct consequences of the rapid expansion of global outsourcing and division of labor made possible by the revolution in information and communication technology. In addition, a large proportion, over 50 percent, of the Chinese export operations consists of "processing and assembly" activities—the final assembly/finishing of products using intermediate inputs produced elsewhere. What used to be exported from Japan, Hong Kong, South Korea and Taiwan to the United States are now increasingly finally finished and exported from China, using components and parts supplied by these economies and elsewhere. The continuing growth of the Chinese trade surplus with the United States is a direct consequence of the shifting of the location of final assembly/finishing of many goods from these East Asian economies to China. The finished goods are considered to have originated from China when they are exported to their final users from China. As a result, simultaneous with the rise of the Chinese trade surplus with the United States, the trade surpluses of these other East Asian economies vis-à-vis the United States decline, or stop growing, and the trade surpluses of these economies with China rise. In other words, a significant part of the trade surpluses that these economies once

had with the United States have been shifted to and "inherited" by China (see Appendix Table 2). For example, during the first half of 2003, China had trade deficits of US$7 billion, US$10 billion, US$18 billion and US$7 billion with Japan, South Korea, Taiwan and the ASEAN countries respectively (see Appendix Table 3). The Chinese trade deficit in goods and services vis-à-vis the rest of the World may be expected to continue to rise in the future because of the rapid growth of oil imports (driven by rapidly increasing domestic demand for automobiles) and outbound tourism.

However, precisely because the Chinese firms are mostly engaged in assembly/finishing operations, despite the high gross value of Chinese exports, the domestic value-added content of Chinese exports to the United States is low—it may be estimated at 20 percent. (Equivalently, the import content of Chinese exports to the United States is a high 80 percent.) The domestic value-added content of Chinese exports to the World is higher, at 30 percent. Chinese exports to the United States may be estimated to be no more than 10 percent of Chinese GDP. (Chinese exports to the World are not quite 30 percent of Chinese GDP.) Thus, the Chinese GDP attributable to Chinese exports to the United States is no more than 2 percent. The percent of Chinese GNP attributable to Chinese exports to the United States is most likely even smaller because most of the profits from such exports accrue to the foreign shareholders and owners of the exporting enterprises and clients of Chinese subcontractor firms.

Yet, this global outsourcing of the assembly/finishing operations, which require relatively low skill levels, to the lowest cost subcontractors, also strengthens the competitiveness of U.S. firms in their home markets and helps them to not only maintain their existing markets but also open new markets for U.S. products in the rest of the world. For examples, Dell may not have been able to compete with Acer without the cost savings resulting from the final assembly of its personal computers in China (typically by its contractor); Motorola may not have been able to compete with Samsung without its production and export base for mobile telephones in China; and Hewlett-Packard may not be able to compete with Epson without manufacturing overseas. Competition is worldwide today and not just limited to U.S. markets. However, as mentioned previously, the Chinese value-added is very low because almost all components and parts, especially the high-value ones, are imported. Thus, while China may have the dubious honor of being the world's largest shoe manufacturer, Nike has become the world's most profitable footwear firm without manufacturing a single pair of shoes. More generally, the global outsourcing enables U.S. firms to both maintain their domestic market shares and expand their global market shares and thereby maintain, create and expand better-paying job opportunities in the United States. The bulk of the jobs won by Chinese workers as a result of global outsourcing were from the other East Asian economies, and not from the United States—we lost those decades ago.

The fact that Chinese exports have a low domestic value-added content has a couple of important implications. The first has to do with the relative gains from trade. The domestic value-added content of Chinese exports to the United States, as mentioned above, is only 20 percent. The domestic value-added content of U.S. exports to China is much higher. (The top 5 U.S. exports to China in 2002 are: (1) Aircraft and associated equipment; (2) Thermionic, Cold Cathode and Photocathode Valves; (3) Telecommunication Equipment; (4) Oil Seeds and Oleaginous Fruit; and (5) Measuring/Checking/Analysing Instruments.) The adjusted Chinese exports to the United States is approximately US$105 billion, f.o.b. and the adjusted U.S. exports to China is approximately US$27.5 billion, f.o.b. If we assume the U.S. domestic value-added content is 60 percent, then the domestic value-added of Chinese exports to the United States is US$21 billion and the domestic value-added of U.S. exports to China is US$18.5 billion. These two numbers are not that far apart and 60 percent may well be an under-estimate of the domestic value-added content of U.S. exports to China. In terms of value-added created in each country, the gains from trade between U.S. and China seem not to be too inequitably distributed.[1]

The second has to do with the potential effectiveness of a revaluation in the exchange rate of the Renminbi, the Chinese currency, in reducing Chinese exports to the United States and thereby stemming the loss of jobs. The low domestic value-added content of Chinese exports to the United States implies a high import content. Thus, a revaluation of the Renminbi, while it raises the cost of processing and assembly in China, also lowers the cost of the imported intermediate inputs, which constitute 80 percent of the total cost of the product, at the same time. A 10-percent revaluation will therefore increase the cost of Chinese exports to U.S. importers by approximately 2 percent. It is therefore unlikely to have a significant effect in reduc-

[1] In addition, the United States has a surplus in trade in services of more than US$ 2 billion, and there the domestic value-added content is almost 100 percent.

ing Chinese exports to the United States. The postwar Japanese experience is hardly encouraging on this question. The Japanese Yen appreciated from 360 Yen/US$ in the early 1960s to its current 115 Yen/US$, but the revaluation did not seem to have reduced the Japanese trade surplus vis-à-vis the United States. Mere revaluation of an exchange rate seldom works and will not in this case. It is far more important, and effective, to change the mercantilist mindset prevalent in these countries.

There are also additional reasons why a revaluation of the Renminbi is unlikely to help very much. Most macroeconomists will tell us that our trade deficit is the direct consequence of our savings-investment imbalance, that unless we save more and consume less, the balance of payment deficit is likely to continue. Even if the Renminbi is significantly revalued, and the revaluation is effective in raising the prices of Chinese exports, it may merely lead to diversion of processing and assembly activities from China to third countries with similarly low costs.

China and the United States do not compete in any export markets. The U.S. does not export anything that China exports. Similarly, China does not export anything that the United States exports. The two economies are actually quite complementary. In terms of reducing the U.S. trade deficit, it is far more effective to have a revaluation of the currencies of countries that compete directly with the United States in export markets, which should increase U.S. exports. For third countries like China, it is not the values of their exchange rates vis-a-vis the U.S.$ that determine whether they will buy from Airbus or Boeing, it is the Euro/US$ exchange rate. Finally, a precipitous revaluation of the Renminbi may lead to a flight from the US$ by Chinese nationals, possibly driving up the rate of interest in the United States.

We may note that both Dr. Glenn Hubbard, the former Chairman of the Council of Economic Advisers, and Dr. Gregory Mankiw, the current Chairman of the Council of Economic Advisers, have said that a revaluation of the Renminbi is unlikely to be very effective in reducing job losses in the United States.

Revaluation of the Renminbi, even unaccompanied by the removal of outbound capital control, is also likely to pose some risks to the financial institutions and enterprises in China because of the requirement of "marking to market." For example, the People's Bank of China (PBOC), the central bank, holds approximately US$360 billion of foreign exchange reserves, with perhaps more than 70 percent of which denominated in US$. It will have to take a massive write-down in Renminbi terms upon revaluation. (PBOC holds approximately US$126 billion of Treasury securities, and also Fanny Mae and Freddy Mac securities.). It has been estimated that an additional US$150 billion are held by Chinese enterprises and households as deposits at Chinese commercial banks. A full-fledged banking crisis may ensue if Chinese commercial banks have to write down their currency losses.

It is probably counterproductive for the United States to demand that China do something that is costly to China but does not do the United States any good. Forcing China to revalue does not really help us solve our job problem fundamentally.

We next address the question of whether the market for foreign exchange in China is in equilibrium (a related question is whether the Renminbi is undervalued). There actually has been a cumulative real exchange rate appreciation of the Renminbi versus the U.S. Dollar of approximately 15 percent since January 1, 1994. The Chinese current accounts are at the present time approximately balanced vis-à-vis the World as a whole despite large surpluses vis-à-vis the United States, with only a small surplus of approximately US$10 billion expected for 2003. However, the Chinese overall balance of payments is in disequilibrium with a significant surplus, mostly because of the large capital inflow on account of the inbound foreign direct investment (FDI), currently running at a rate of US$60 billion a year. But the capital accounts are in surplus also because of controls on capital outflows. Only inflows of capital but no outflows of capital are permitted (with some exceptions) in China. Thus, while it is true that the Renminbi exchange rate is not "market-determined" by spot supply and demand, whatever exchange rate that may emerge from simply eliminating the government intervention in the foreign exchange market is not a truly market-determined exchange rate either, because many potential buyers of foreign exchange and sellers of Renminbi have been excluded. If capital controls are lifted tomorrow, it is not clear that the Yuan will appreciate. Dr. Nicholas Lardy of the Institute for International Economics, Dr. Stephen Roach of the Morgan Stanley, and Dr. Weijian Shan, a General Partner of Newbridge Capital all seemed to believe that the value of the Yuan in terms of U.S. Dollars will go down, not up, if capital controls are lifted. I personally do not share their view. However, lifting capital controls abruptly is extremely risky—it may trigger a massive financial crisis in China. If Chinese depositors withdraw their deposits from the Chinese commercial banks and exchange them into U.S. Dollars en masse, the commercial banks

may be faced with an illiquidity and insolvency crisis, because of the extraordinarily high proportion of nonperforming loans in their portfolios. In addition, the apparently large official foreign exchange reserves held by China can be very quickly depleted, putting great downward pressure on the Renminbi. Standard and Poor, the rating agency, supports the decision of China not to revalue the Yuan on the grounds that a floating of the currency will damage China's credit rating.

One can of course also try to correct the disequilibrium in the foreign exchange market through quantity adjustments rather than price adjustments, i.e., revaluation. Quantity adjustments imply increasing the imports of goods and services, promoting outbound direct and portfolio investment, and financing inbound direct (and even portfolio) investment with Renminbi-denominated loans. But above all, it means changing the mercantilist/fish-trap mentality.

First, China can afford to run a significant trade deficit, given its substantial foreign direct investment inflow, and it can and should import more from the United States. The trade imbalance can be corrected in two ways—decreasing imports or increasing exports. Rather than making the Chinese sell less to us, it is far better for us to encourage them to buy more from us. Given the levels of Chinese exports and imports and external debt levels relative to its GDP, there is no need for the Chinese central bank to continue to accumulate foreign exchange reserves. One caricature of what has been happening for the last few years is the following: Chinese firms exchange goods for greenbacks, pieces of paper that can be printed at virtually zero cost; they sell the greenbacks to the Chinese central bank for Renminbi; and the central bank in turn exchanges the greenbacks for other pieces of paper, call bonds, which can also be printed at virtually zero cost. Holding too much paper is not without risk. At some point the Chinese should turn back some of the pieces of paper for some real goods. Special high-end consumer products, such as Harley-Davidson motor cycles and Corvette cars, can have a significant market in China, but require promotion. There is also always a high demand for high technology capital goods, and perhaps an expedited procedure for processing applications for export control waiver can help. U. S. firms can also provide more services to China, in the areas of telecommunications, transportation, logistics and distribution activities, financial services, and e-Commerce. Leisure time activities and entertainment—sports exhibition, movies, etc.—are another promising area. There is also a great deal of room for growth in the provision of invisible/intangible "exports" of services—tourism (China has really opened up tourism in a big way—travelers are permitted to take US$5,000 out of the country per person per trip; individuals can now have passports that are valid for years as opposed to just a single trip; and individual tourism is now a legitimate reason for traveling abroad); education (more Chinese students for universities and graduate schools in the United States), and healthcare (medical treatment) in the United States. Finally, enhanced intellectual property rights protection in China can greatly augment U.S. exports of goods and services to China.

China can also offer to finance the inbound foreign direct investment (FDI) of foreign direct investors with Renminbi-denominated loans, providing a natural hedge to foreign direct investors but at the same time reducing the inflow of foreign exchange, which China, with a savings rate of 40 percent, does not need (such loans, however, must be with recourse to the ultimate parents in order to avoid moral hazard). China can also make it easier for foreign direct investors to repatriate their principal and profits. Outbound foreign direct investment, especially strategic foreign direct investment, should be promoted and encouraged. For example, Chinese textile firms may be encouraged to invest in the U.S. textile industry. There may well be complementarities and synergies between industries on the decline in one country but on the rise in the other. Many of the benefits and costs of international trade can be internalized. In particular, the potentially displaced workers can be compensated by the potential beneficiaries of the trade, who can, in turn, pass the cost to the general public by charging slightly higher prices. Chinese firms can also be encouraged to make strategic investments in listed and unlisted companies in the United States and elsewhere. Tax treaties should be concluded between China and the United States and other countries so as to facilitate Chinese outbound foreign direct investment. China can also increase foreign aid and foreign loans to multilateral organizations and low-income developing economies—e.g., loans repayable in the local currency.

Instead of floating their shares on the overseas markets, good Chinese firms should be encouraged to offer their shares domestically (China does not need any more foreign exchange), where in fact the price/earnings ratios are much higher. China should also begin to relax its capital control by allowing regulated orderly outflows of portfolio investments through approved instruments or vehicles, e.g., qualified domestic institutional investors (QDIIs), closed-end outbound publicly list-

ed and traded mutual funds (e.g., S&P500 indeed funds), and China Depositary Receipts issued by U.S. and other foreign publicly listed companies and listed and traded on the Chinese Stock Exchanges.

Are there other promising alternatives for reducing the disequilibrium in the overall balance of payments to a revaluation? The answer is yes. First, an acceleration of the World Trade Organization (WTO) commitments on tariffs, market access and opening can be extremely helpful. Second, the imposition of import tariffs by the United States. However, this may not be very effective, because the supply of imports can simply come from another country. And discriminatory import tariffs may not be permitted under WTO rules.

A potentially interesting idea is that of "Voluntary Export Tax (VET)". Export taxes are generally permitted under WTO rules (either vis-à-vis the United States or vis-à-vis the rest of the World). An export tax is better for China than a revaluation because while it enhances the terms of trade in the same way as a revaluation but it does not lead to losses for holders of the U.S. dollars, e.g., the People's Bank of China or other commercial banks and enterprises that may have to recognize the foreign exchange losses. It also does not generate windfall gains for the holders of the Renminbi and thus does not reward currency speculators or encourage continuing currency speculation. Moreover, an export tax can be easily lifted if and when the balance of payments conditions so warrant. For the United States and other importers of Chinese goods, an export tax of 2 percent is equivalent to a revaluation of 10 percent. An import subsidy also has the same effects on trade flows as a revaluation or an export tax. However, from a fiscal point of view, an export tax is preferable because it generates revenue whereas an import subsidy requires expenditure.

Volatility of the exchange rate is not conducive to long-term trade and investment relations—long term effective hedges are hard to find and expensive. However, a wider band of fluctuation around a stable mean exchange rate is a good idea but should be introduced and implemented only when expectations of future exchange rates are more neutral and diffuse. If expectations are all one-sided, introducing a wider band does not help because the top of the band will be reached immediately, possibly leading to expectations of even further movements in the same direction. China should not revalue now, because then it will encourage continuing speculation and pressure to revalue. Moreover, it is always easier to revalue than to devalue. Devaluation is likely to face much more opposition than a revaluation. The U.S. may object, assuming that it continues to be in a net deficit position. Objections and competitive devaluation by other exporting countries competing in the same markets can be expected with a devaluation but not with a revaluation. Finally; the perception of the domestic population may pose an obstacle to devaluation because the currency is also regarded as a store of value and devaluation may be regarded as a sign of weakness of the economy or mismanagement. When the long-term value of the currency is uncertain, as is the case for the Renminbi, it is better to stay put rather than revalue or devalue.

The best strategy for us is probably to focus on achieving the outcome that we want, e.g., an overall Chinese balance of payments of approximately zero, and not on the method for achieving it.[2] We should hold China to the achievement of the outcome, but leave the choice of instrument, or combination of instruments, to China. We have advised the Japanese Government to revalue the Japanese Yen quite a few times, which it dutifully did each time, but the revaluations never achieved the desired outcome—a reduction or elimination of the large Japan-U.S. trade surplus—the trade surplus only became bigger. We should have asked the Japanese Government to simply reduce its overall balance of payments surplus, in whichever way that it thinks it can.

Chinese economic policymakers are committed to the gradual evolution to a market based exchange rate determination mechanism. Going forward, the most important task facing the Chinese economic policymakers is to lay the groundwork for the orderly and regulated relaxation of the controls on the different types of capital outflows, with the objective of achieving an equilibrium in the overall balance of payments. Then gradually, with the overall balance of payments continuing to be in approximate equilibrium, additional types and higher volumes of capital outflows can be liberalized until the ultimate objective of free convertibility is achieved.

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[2] Of course, a Chinese overall balance of payments of zero, while it implies that China will have a significant deficit in the current accounts (principally the trade in goods and services) with the World as a whole, it does not necessarily imply that the U.S.-China bilateral trade deficit will be smaller. However, the expectation is that the overall trade deficit of the United States vis-à-vis the World as a whole will be reduced as China or other economies, making use of their trade surpluses with China, increase their imports from the United States.

APPENDIX TABLES

Table 1.—Estimate of U.S.-China Trade Balance, f.o.b., Adjusted for Re-exports, Re-export Markups and Services

(Billions of US$)

Year	Our estimate of U.S. imports from China fob adjusted for re-exports and re-export markups (Official U.S. data)	Our estimate of U.S. exports to China fob adjusted for re-exports and re-export markups (Official U.S. data)	Estimate of U.S. exports of services to China (Official U.S. data)	Estimate of U.S. imports of services from China (Official U.S. data)	Our estimate of U.S.-China trade balance of goods and services (Official U.S. data)
1995	33.7	16.0	2.5	1.7	−16.9
1996	38.7	17.1	3.2	1.9	−20.3
1997	48.2	18.0	3.6	2.2	−28.8
1998	56.3	18.9	4.0	2.3	−35.7
1999	65.1	17.7	3.9	2.7	−46.2
2000	80.3	21.4	4.6	2.8	−57.1
2001	83.5	24.7	5.3	3.0	−56.5
2002	104.0	27.4	5.3	3.0	−74.3

Sources: Fung and Lau "Adjusted Estimates of United States-China Bilateral Trade Balances: 1995–2002," Asian Economic Journal, Vol. 14, May/June 2003, pp. 489–496.

Note: The official 2002 U.S. data on exports and imports of services are not yet available. We make the assumption that the values of export and import service trade between the United States and China are the same in 2002 as in 2001.

Table 2.—U.S. Balance of Trade

(Billions of US$)

	2000	2001	2002	2003H1
World	($487)	($448)	($509)	($268)
China	($90)	($90)	($111)	($54)
Japan	($85)	($72)	($73)	($32)
Hong Kong	$3	$4	$3	$2
South Korea	($14)	($14)	($14)	($5)
Taiwan	($15)	($15)	($14)	($7)

Table 3.—Chinese Balance of Trade

(Billions of US$)

	2000	2001	2002	2003H1
World	$43	$23	$30	$3
United States	$30	$28	$43	$23
Japan	$0	$2	$6	($7)
Hong Kong	$35	$37	$26	$27
South Korea	($12)	($11)	($11)	
Taiwan		($12)	($36)	($18)

PREPARED STATEMENT OF MARGARET M. PEARSON

SEPTEMBER 24, 2003

Mr. Chairman, Mr. Co-Chairman, and Members of the Commission:

Thank you for the opportunity to testify before you today. I am a Professor in the Department of Government and Politics at the University of Maryland. I have been researching and teaching on China's politics and economy since the mid-1980s, first at Dartmouth College and now at the University of Maryland. One of my areas of expertise is China's participation in the World Trade Organization (WTO).

In my testimony today I wish to address two issues related to China's rule of law development, which is of course a core part of the Commission's mandate. The first half of my comments addresses the implementation of China's WTO-related rule-of-law commitments as they are carried out in domestic legal arena. The second part of my testimony addresses China's adherence to international standards in its participation in the WTO in Geneva and related meetings, with particular attention to the recent WTO Ministerial in Cancun.

I. UNEVEN PROGRESS ON CHINA'S WTO-RELATED RULE OF LAW COMMITMENTS

On the first topic—domestic rule of law commitments—I will focus my attention on two subjects: promulgation of rules required by China's WTO accession documents, and development of mechanisms and norms of transparency. I give some attention to where we are in "year 2" of China's membership, but remain cognizant that the real and enduring processes the Commission is interested in require we think with a longer-term metric in mind.

My basic assessment, which I believe is consistent with that of many scholars and practitioners who follow legal developments as they relate to WTO, is that the trends in these areas have not changed much since the Commission issued its Annual Report for 2002. It remains the case that over the past decade China has made great strides in strengthening many aspects of its legal system, including as this system applies to WTO compliance. Despite substantial progress, however, there is no question that China has a long way to go toward fulfilling its commitment on rule-of-law related issues. Its ability to do so routinely will depend on continued evolution of the overall move toward rule of law in the legal system as a whole.

With regard to the promulgation of rules required by China's accession, as has frequently been noted, the Chinese government has established or revised many laws committed to in its WTO accession agreement.[1] Still, we continue to await promulgation of many rules for specific industries. Even where broad laws have been promulgated, detailed implementing rules on market access for foreign firms have not appeared. For example, in year 2 (by December 11) China's WTO accession agreement mandates that several sets of regulations on services be promulgated, but it is not clear that they will be ready.[2] More generally, the pace of law-making and revising has slowed substantially compared to 2 years ago. This slowing is in part because much already has been done, but it also reflects the fact that more difficult and controversial areas are being approached. As time passes, moreover, domestic economic constituencies have mobilized themselves, often in the form of industry associations, and have erected protectionist barriers. Furthermore, new rules that erect new trade barriers, such as on genetically modified organisms (GMOs) and other sanitary and phytosanitary concerns, are being issued. Not all will be judged WTO non-compliant, but some certainly will.

The issue of transparency has received significant attention from the Commission. China's WTO commitments speak explicitly to the issue of transparency by requiring that all regulations related to its WTO commitments be published promptly and in official accessible venues, and that prior to promulgation they be published in draft form and subject to public comment (including by foreign interests).[3] In this realm of administrative law and procedure, the Chinese government has made progress in encouraging that laws are published, transparent, promulgated only after some public comment period, and so forth. Prompt publication of formally issued laws has proceeded especially well; one hears of fewer and fewer instances where foreign businesses are told of an internal (*neibu*) regulation or administrative

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[1] In 2000–2002, China's governmental agencies went through a massive review process aimed at determining which of China's regulations were WTO-compliant. In May 2002 China's Ministry of Foreign Trade and Economic Cooperation (now part of the Ministry of Commerce) announced that more than 2,300 laws and regulations had been amended to comply with WTO rules, and 830 additional laws and regulations had been abolished.

[2] For example, the WTO mandates the promulgation of regulations on direct selling services by December 11, 2003.

[3] The Commission ably summarized these requirements in its 2002 Annual Report (p. 47).

circular that they must abide by yet may not see. There continue to be more instances where drafts have been circulated for public comment with sufficient (if still short) time to receive comment. Some regulatory agencies—notably the China Securities Regulatory Commission—seem quite committed to these procedures.

Nevertheless, many of the same gaps the Commission found in its 2002 Annual Report remain. In particular, the adherence to the public comment commitment is uneven.[4] Too often, binding rules that significantly affect market access are issued without opportunity for comment, as occurred this year with the 2003 Telecommunications Service Classification Catalog.[5] Draft rules continue to circulate without a mechanism for formal comment.[6] Sometimes drafts are circulated only among a few companies (foreign or domestic), often just those former government monopolies with close ties to the regulator. Public comment periods, even when offered to a broad range of Chinese and foreign companies, are often too short. Many observers had also hoped that the WTO-based requirements for transparency also would help open the policy formulating process to greater scrutiny, though this is not mandated by WTO. There continues to be disappointment on this front as well.

China has committed to these transparency norms and to the promulgation regulations that enshrine the principles of market access and national treatment. Difficulty in adhering to these commitments cannot be excused. But the difficulties can be explained. To what, then, can we attribute this continued slow implementation? At this point, substantial education of officials—funded by the Chinese government and foreign public and private sources—has been completed. It is no longer compelling to attribute the gaps to a lack of understanding.[7] Several explanations are more compelling at this juncture. First, there continue to be poor coordination mechanisms between the myriad agencies that often must be involved in the promulgation of any new rules. Indeed, while there is often a lead agency for drafting, another agency or set of agencies may do the issuing of the rule. Poor ability to coordinate internally can easily spill out to poor coordination on the external comment requirements. Bureaucracies may shy away from public comment and prior notice, even though they are not required to do anything with the comments, because they complicate the internal negotiations and bureaucratic wrangling that accompanies the promulgation of many new rules.

A second structural obstacle to implementation of rule of law obligations is the ongoing administrative reorganization. I refer not merely to the immediate past reorganization following the National People's Congress in March 2003,[8] but more generally the longer term establishment of new regulatory agencies and re-division of authority between existing ministries, bureaus, etc. The administrative lines of authority remain unclear and poorly institutionalized, and continue to make the rulemaking process quite contentious.

Finally, the norm of transparency, though gaining ground domestically, is not yet reflexive. Not until the norm is fully grounded in domestic law will it to become an entrenched part of the domestic legal and administrative landscape. The promulgation of an Administrative Procedure Law, now in draft form, is expected to lay out detailed procedures that administrative units must follow, including procedures to enhance transparency.[9] A similar slow process appears to be underway with regard to establishment of independent judicial review of WTO-related administrative actions.[10]

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[4] One recent example that has received much attention is that when China revised its auto policy regulations it did not issue the drafts publicly or provide foreign companies an opportunity to comment.

[5] The catalog was posted on the Ministry of Information Industry web site with an effective date 2 weeks following release and no vehicle for soliciting comment. This catalog is crucial because it classifies telecommunications services into basic services and value-added services, a distinction of great importance to foreign firms because, for example, the former category is much more protected than the latter.

[6] This has been reported with regard to draft laws on retail, franchise and direct selling. See US-China Business Council, "China's WTO-Implementation: A Mid-Year Assessment" (US-China Business Council, 2003).

[7] This is not to say that much can be done to build capacity in important areas—notably in the areas of judicial review and enforcement of regulations.

[8] The most pertinent example is the combination of the Ministry of Foreign Trade and Economic Relations (MOFTEC), which has lead responsibility for many aspects of WTO implementation, with the State Economic and Trade Commission (SETC) into a new Ministry of Commerce.

[9] On the importance of incorporating China's WTO obligations in domestic law to be fully authoritative, see Donald C. Clarke, "China's Legal System and the WTO: Prospects for Compliance," Global Studies Law Review, 2003.

[10] On independent judicial review of WTO-related administrative actions, I refer the Commissioners to the study by Veron Mei-Ying Hung, "China's WTO Commitment on Independent Judi-

Thus, while it is still possible to point in year 2 to progress in the rule-of-law domain, the unevenness that has been present throughout the compliance process remains. The continuing unevenness, deadline missing, and so forth, is generating greater anxiety and disappointment in the foreign community than it was a year ago, as it appears that these problems are in danger of becoming a permanent part of the implementation process and not merely a reflection of first-year missteps or even leadership transition and SARS. Goodwill is dissipating among many foreign observers and business interests.

Amidst this frustration, it is worth repeating that deep and enduring progress on many of the rule of law issues of concern to the Commission—not just as regards China's WTO compliance, but also more broadly reform of legal procedures and processes, improvement in transparency, establishment of an independent judiciary, and so forth—are, and will continue to be, driven foremost by internal processes. By internal processes I refer primarily to the development of domestic constituencies, either within or outside of the government, with an interest in seeing deep rule of law oriented reforms. Such reforms can be encouraged and fostered by WTO compliance efforts, but except insofar as they support the development of domestic constituencies, they will contribute primarily at the margins. I am optimistic that there will be improvement over the medium term on these issues, but as a result of domestic trends that both pre-dated and go much deeper than China's WTO implementation.

II. CHINA'S ADHERENCE TO INTERNATIONAL STANDARDS IN THE WTO PROCESS IN GENEVA

The second issue I wish to address brings a different perspective to rule of law issues than has been addressed previously in this forum. This perspective examines China's activity in WTO in Geneva and at related international meetings, including the WTO Ministerial in Cancun 2 weeks ago.

Prior to China's becoming a member of the WTO, the question was often raised in Washington and elsewhere as to whether China would become a "revisionist" power in the WTO, attempting to change the rules and challenge the norms by which it operated. At that time, I argued that based on China's behavior in other multilateral economic institutions, China was unlikely to be a revisionist power but, rather, would in most cases "play by the rules."[11] Now that China has been a member for nearly 2 years, it is useful to evaluate its actual behavior in Geneva.

Prior to engaging in an assessment, however, it is important highlight a distinction about the use of the term "cooperation" as applied to China's WTO behavior. We must be careful not to conflate the notion of "cooperative behavior" with "adherence to the agenda of the United States." We may strongly prefer that China's agenda in the Doha Round decisions are aligned with those of the U.S. Government. But cooperative behavior in the WTO must be measured in terms of whether a country abides by the rules and norms established by the organization as a whole. In other words, does China adhere to the "rules about rules" of the organization?[12] It is useful to keep in mind, for example, that some of the closest political allies of the United States may pursue agendas in some areas of the WTO that are quite inconsistent with our own. Hence, a huge number of disputes brought to the Dispute Resolution Mechanism in Geneva involving the United States also involve many close political and trading partners. At the level of day-to-day negotiations, then, "cooperation" cannot be defined by an absence of conflict with other nations, since conflict over trade interests is assumed and built into the process. Moreover, coalitions shift from issue to issue.

In the PRC's first year of membership in WTO, we can conclude that it did not pursue a revisionist agenda.[13] There are two major exceptions, discussed below, that cut at core issues of Chinese sovereignty. Yet the answer to whether China has been a "cooperative" power in the WTO is, by and large, "yes." The Chinese delegation has made no effort to change the conservative consensus rules of the WTO. The in-

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cial Review: An Opportunity for Political Reform," Working Paper Number 32 (Washington D.C.: Carnegie Endowment for International Peace, November 2002). Hung discusses the moves made toward establishing independent judicial review by basing it on the Administrative Litigation Law, but also notes the political constraints in achieving such independent review that can only be solved in the longer term and as a result of broader political reforms.

[11] Margaret M. Pearson, "China's Track Record in the Global Economy," in China Business Review, 27:1 (January-February, 2000): 48–53.

[12] A classic statement of this metric is Abram Chayes and Antonia Handler Chayes (1993), "On Compliance," International Organization, Vol. 47, Issue 2 (Spring), pp. 175–205.

[13] A longer version of this analysis, for the period up to June 2003, is Margaret M. Pearson, "China's Multiple Personalities in the WTO," in New Trends in the Study of Chinese Foreign Policy, edited by Alastair Iain Johnston and Robert Ross (manuscript pending review).

formal processes to which the consensus rules give life are also accepted, notably the norm of non-interference in issues where a country's core interests are not involved. (In this, China's behavior can be contrasted with that of India.) China has welcomed the expectation of other countries, including the United States, that it should be—must be—an active participant in major WTO decisions, whether made formally or informally. China has made several moves to help give developing countries more voice, but except in the case of the meetings earlier this month in Cancun, these moves have not been particularly disruptive. And in all these moves China has been much more a follower than a leader.

China for the most part has not made its presence strongly felt in Geneva, moreover. The PRC delegation has spent considerable energy coming up to speed on the rules and norms of the organization, as well as on the TRM process, as discussed below. The delegation remains small and understaffed, and thus lacks capacity to pursue an aggressive agenda across. Moreover, domestic consultative arrangements have not been established to allow for the formulation of a cohesive trade policy, further hindering the ability to act aggressively within the WTO.

Despite this overall pattern of cooperation, there are two issues on which China can be judged as conflicting fundamentally with WTO rules, norms, and expectations: Taiwan's membership, and the TRM. These issues are perceived in China as impinging on the PRC definition of a sovereign concern, and as a result China treats them in more rigidly category.

Taiwan became a WTO member just following China's accession. The PRC's treatment of Taiwan's membership echoes its behavior in other multilateral institutions, although it is perhaps in some ways less rigid. At times members of the PRC delegation have been willing to meet informally with their Taiwanese counterparts (as in APEC, for example), and has dealt with the Taiwanese delegation in formal settings (such as responding to questions from Taiwan in the TRM context. More routinely, though, the PRC has broken the WTO norms for dealing with other members, notably using Chinese in communications rather than one of the official languages of the WTO, insisting on meeting in hotels rather than in the Geneva organization's buildings, and frequently refusing or canceling scheduled consultations on trade issues. The PRC delegation also has conflicted with the Taiwanese delegation with regard to issues of nomenclature and the status of the Taiwan mission. The effort is to ensure that reference to Taiwan's membership in the WTO not imply sovereignty for Taiwan. Most recently, in the spring of 2003, the WTO Director-General Supachai Panitchpakdi approached the head of the Taiwan delegation and, in essence, requested Taiwan to accept a downgrading of its status from "permanent mission" to "office of permanent representative," and to affirm that the actions regarding WTO representation of Taiwan have no implications for sovereignty. The PRC appears to have been working through the lead agents of the WTO in an attempt to lend legitimacy to its pressure.

The Transitional Review Mechanism (TRM) is a process established in China's accession protocol (and is unique to China) to review annually China's progress in implementation for the first 8 years of membership.[14] The TRM is enormously unpopular in China. It is a focus point for PRC concerns about national humiliation and sovereignty, all the more aggravating because Chinese leaders agreed to submit to it. It also is evocative of the annual most favored Nation status debate in the U.S. Congress during the decade prior to China's WTO admission. However, unlike the MFN debate, China has a direct role in the TRM process and is therefore positioned to be much more defiant.

It was in this context that the first TRM review occurred a year ago, in the fall of 2002. Under pressure particularly from the United States, discussion of problems with PRC compliance was initiated several months prior to the formal review scheduled to take place in December. The PRC's formal response was threefold: compliance issues should not be brought up significantly before the formal date of the review; China would respond to the issues raised, but only to the letter of the law and as such would only provide oral answers; and other discussions about compliance should take place in informal and/or bilateral settings. The debate was acrimonious. As China resisted giving full answers it became subject to much criticism. This left a bitter taste in the mouths of many in the foreign trade bureaucracy. It

[14] All members are subject to a periodic "Trade Policy Review " (TPR) of their trading practices, a review that takes place within the Secretariat office. Reviews of China are not only more frequent than for other governments (compared for example to biannually for the U.S. and EU) but also involve multiple functional councils. This "WTO-plus" commitment was established as a response to the fact that China was to be admitted prior to its full compliance with the terms of membership set for it. See Paragraph 18 of the accession protocol.

is likely that the PRC will explore ways to minimize the impact of the TRM in the current and coming years. I will come back to this point subsequently.

With the exception of these two sovereignty-regarding situations, though, the PRC's behavior in Geneva cannot be judged to be revisionist or uncooperative. Indeed, U.S. officials were hopeful for cooperation on a range of issues. With regard to one major issue on the Doha agenda, agriculture, Chinese trade officials had expressed publicly and privately that cooperation with the US was quite possible on the proposal Ambassador Zoellick and Secretary Veneman put forward last year.

It was thus contrary to expectation that China might join what is now known as the Group of 22 developing countries in putting forth a counterproposal to that of the EU and the United States at China's first ministerial meeting in Cancun earlier this month.[15] In large part as a result of the stalemate between the two blocs, the meetings failed to produce an agreement on modalities for further agricultural negotiations. The main complaint of developing countries was that the working draft did not go far enough to commit to cuts in agricultural subsidies by developing countries, while at the same time asking for tariff reductions by (and with only a modicum of "special and differential treatment" for) developing countries. Developed countries have argued that the developing countries cannot expect the developed countries to make all the compromises, and that a breakdown in negotiations does not further the agenda of the developing countries, which need progress on agricultural negotiations more than the wealthier agricultural nations.

While the internal PRC dynamic leading up to China's participation in the coalition is not yet fully clear, greater clarity can be shed on what occurred from the PRC point of view. China, which agreed in its own WTO accession agreement to lower tariffs, subsidies and supports than virtually any other country, is in the process of defining its own agricultural trade interests.[16] The Chinese government is pinning increasing hopes on agricultural exports—primarily to its Asian neighbors that maintain high agricultural tariffs—to help ease rural poverty and unemployment. In this, it shares interests with the United States and Cairns Group, as well as a number of developing countries (but not India). It also has an interest in leveling the playing field in subsidies, which it claims it cannot afford. Its concrete interests therefore are split between a developing and developed country agenda.

How, then, should we assess China's membership in the Group of 22? First, China's willingness to join with developing countries on this issue is an important stand, and does lend weight to the developing agenda. Previous efforts to solidify a development agenda in agriculture did not get far, and China's entry into the fray is certainly part of the reason for the greater hearing to the development agenda in WTO. Having said that, China's role in this coalition was to lend support, but not to lead it or attempt, in rhetoric, to make the discussion more vituperative. The initiative for the coalition lay clearly with Brazil and India, notwithstanding the fact that China's name appeared routinely in articles on the coalition. Indeed, it has appeared quite aloof. China's delegation to Cancun, led by Minister of Commerce Lu Fuyuan, did not seek headlines. Lu's comments to the media conference where the G22 made its major statements were much more conciliatory than those of other participants, saying China "hoped the Ministers would consider the G22 text even as they are considering the Chairman's draft" (emphasis added). In contrast, for example, the Argentinean Minister said the paper "must" be accorded the same basis as the chair's text, while the Brazilian Foreign Minister stated that it was essential that the group's paper be taken as a basis for negotiations.[17] As discussions among

[15] The WTO's Fifth Ministerial Conference was held September 9–14, 2003, in Cancun Mexico. The major substantive item on the agenda was decision on the framework for modalities for agriculture negotiations in the Doha Round. The working draft to be considered as the basis negotiations was the text submitted by the General Council chairman, Uruguay Ambassador Carlos Perez del Castillo. This draft was seen by the G22 as too close to the draft the United States and EU had agreed to several weeks earlier, and ignored concerns raised in a draft paper submitted in response by the group in August.

[16] China agreed in its accession agreement to reduce average tariffs on agricultural imports to 15 percent by January 2004, to domestic supports of no greater than 8.5 percent, and a reduction of export subsidies to zero upon WTO entry. These agreements are summarized in Nicholas Lardy, Integrating China Into the World Economy (Brookings Press: 2002).

[17] Statements given at the September 8, 2003 media event are reported in Martin Khor, "Developing Countries Prepare for Agricultural Battle at Cancun Ministerial," TWN Report, September 9, 2003. The number of countries in the coalition changed over the course of the meetings from 20, to 21, to 22—hence the differing monikers (G20, G21, and G22).

ministers were becoming particularly fractious, moreover, Lu intervened to point out that stalemate (which of course eventually occurred) was in nobody's interest.[18]

Moreover, China's media has barely reported the activities of China in the G22. The reports that have appeared have been descriptive and factual. No major analysis of the coalition and China's concrete role in Cancun has appeared in the press. No effort is being made to undermine the legitimacy of WTO processes, or to promote the idea that China is a developing country and working against the interests of the United States and EU.[19] The key message is that China hopes to play a cooperative role in moving negotiations along in the future.

China therefore has positioned itself, as in past statements in the WTO, to serve as a "bridge" between the developing and developed country agenda. Such behavior has more than a diplomatic function; it also allows China to maneuver in the future within the complex agenda, not having burned any bridges, to best meet its evolving view of its agricultural trade interests. Its doors are still open to diplomacy from all sides. In other words, it allows the government maximum flexibility in its ability to form coalitions. This is quite consistent with China's behavior across a range of multilateral institutions. In addition, there is a bilateral function to be served. Despite substantial bilateral tensions with India, both countries are trying to move ahead with international cooperation. Brazil and China, too, have made efforts to shore up their relationship in recent years. China's responsiveness to their initiatives is likely to have played a part in the PRC receptiveness to the coalition. Moreover, as China faces another TRM round in the fall, it can perhaps leverage its support for the cause of the developing world into support for its own efforts to shape the TRM process.

Returning to the fundamental question of this portion of my testimony, while China's behavior was inconsistent with the position the United States took at Cancun, its actions were well within the scope of legitimate actions in the WTO—they did not breach dominant accepted norms. China's position reflects the complexity of the situation and its own evolving interests. Rather than closing the door to cooperation with any side, it remains open to conciliation.

PREPARED STATEMENT OF YASHENG HUANG

SEPTEMBER 24, 2003

Thank you for giving me this opportunity to testify about an immensely important and complicated issue in the Sino-US relations as well as in the transition of China to a market-based economy.

The topic of the hearing is, "Is China playing by the rules? Free trade, fair trade, and WTO implementation." In my testimony, I will not address the question whether China is playing "fair" as I believe that fairness is an intrinsically subjective and political perspective. The first question in the fairness question is fairness to whom. If you hold the view that the cheap Chinese imports are "unfair" to those US firms producing the same products, one can equally argue that these imports are "fair" to those Americans who purchase these products. There are also American corporations which purchase imported intermediate products to manufacture their products. By this logic, those consumers who purchase America-made products that use imported intermediate products from China also benefit from cheap Chinese imports.

As much as I can, I will stay away from this so-called "fairness" question because I respectfully submit that this question itself is poorly defined. What I want to do here is to provide an analytical perspective based on facts and evidence rather than getting into a more complicated issue as to whether China's trade and investment practices are fair or not. I am also testifying here in my capacity as a business school professor who analyzes business and economic trends in China rather than as a lawyer who follows the detailed legal and regulatory issues involved in the WTO implementation. What I want to do here is to provide some general backgrounds relating to the role of foreign direct investment (FDI) and foreign trade in the Chinese economy. My argument is that assessing China's accession and imple-

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[18] Peter Wonacott and Neil King, "China Moves Quietly to Push Trade Goals: Beijing, Balancing Needs to Its Farmers, Factories, Treads Softly at WTO Talks," Wall Street Journal, September 15, 2003.

[19] See for example reports appearing at: www.people.com.cn/GB/jingji/1037/2085439.html; www.chinanews.com.cn/n/2003–09–12/26/345847.html; www.chinanews.com.cn/n/2003–09–04/26/342800.html; www.china.org.cn/chinese/EC-c/401659.htm; www.china.org.cn/chinese/2003/Sep/403738.htm; finance.sina.com.cn/g/20030917/0753448722.shtml; PRC to Support Future WTO Talks; Promote Interests of Developing, New Member Nations," Xinhua (English), Sunday, September 14, 2003.

mentation of WTO against this general economic background can yield a very different conclusion from assessing China's WTO implementation against the specific provisions in China's accession document. I believe that China's WTO implementation should not be judged on narrowly legal grounds but on the broader economic and social grounds.

There are three general points I want to make and emphasize in my testimony. First, China acceded to the WTO terms not as a closed economy but as a substantially open economy. In fact, by some measures, China is more open to FDI and foreign trade than the United States. This is a remarkable fact and we need to keep this in mind when we judge China's implementation record. Even if China were to have failed to implement each single provision of the WTO accession document, we cannot draw the conclusion that this is a closed economy designed to keep out foreigners. My second point is that while we can debate whether cheap Chinese imports are fair to Americans, we can legitimately make an argument that some of the Chinese regulations and practices are in fact unfair to the Chinese themselves, especially to the domestic private entrepreneurs, and the largest beneficiaries of unfair treatments are foreign firms; some are American firms.

The third point is that the fact that China appears to be quite open to foreign trade and FDI is in part a result of some fundamental inefficiencies of its economic system. These inefficiencies suppress the investment and market potentials of truly domestic private firms, which are the most efficient firms in the Chinese economy. The effect of this suppression is that foreign firms have found more business space in China because they do not compete with the most efficient domestic private firms to the extent possible. An implication of this way of looking at the roles of foreign trade and FDI is that as some of these inefficiencies are being alleviated in the long run—5 to 10 years—the importance of foreign trade and FDI may very well decline in the Chinese economy.[1]

Let me organize my comments into three sections. The first section provides evidence to show that Chinese economy, even before the WTO accession, was already quite open and in fact, by some measures, more open to foreign trade and FDI than the United States. The second section explains this "foreign" bias in the Chinese economy—in favor of foreign firms and often to the detriment of domestic private firms. The third section provides some concluding remarks.

THE UNUSUAL OPENNESS OF THE CHINESE ECONOMY

By a number of conventional measures, China's economy in fact is quite open without the benefit of the WTO membership. On the trade side, a large portion of China's GDP is accounted for by foreign trade. Using official exchange rate conversion would yield a trade/GDP ratio of 40 percent, an extremely large share for a continental economy of China's size.[2] For the US, the foreign trade/GDP was around 20 percent in the 1990s. Japan had a similar ratio.

China is also quite open to foreign direct investment (FDI). Since the early 1990s China has been one of the largest FDI recipients in the world. In 1994, for example, China alone accounted for 49 percent of the total FDI flows to developing countries and 15 percent of the worldwide FDI flows. This ratio has declined in more recent years but China no doubt is the largest recipient of FDI among developing countries. For 2003, according to a number of estimates, China will surpass the United States in terms of the absolute level of FDI.

Not only is the absolute size of FDI large, its relative size—measured by FDI/capital formation ratio—surpassed that of many countries in the world (discussed below). I will also provide evidence to show that foreign-invested enterprises (FIEs)—i.e., joint ventures between Chinese and foreign firms or wholly owned foreign subsidiaries—have established a sizable presence in the Chinese economy and, in a number of industries, have come to command a dominant position.

FOREIGN VIS-À-VIS INTERNAL TRADE

The outsized roles of foreign trade and FDI in Chinese economy are not only striking in comparing China with other countries but also in comparing China's dependency on external trade and on FDI with its patterns of internal, cross-provincial

[1] I have made this argument in greater detail elsewhere. See (Huang 2003).

[2] Using the purchasing power parity conversion would yield a lower ratio, but the purchasing power parity measures are plagued by the uncertainty of exactly what constitutes the right purchasing power parity rate. If the "true" trade/GDP ratio is half of the ratio based on the official exchange rate, 20 percent of the GDP in foreign trade is still quite large. In comparison, the same ratio for Japan in 1998 was about 20 percent and for the United States, it was 23 percent for 1994.

trade and investments. In a 1994 report, the World Bank—the best study to date—noted that inter-provincial trade normalized by provincial GDP was smaller than intra-European trade.[3] Transportation costs explain some of this but during the reform era inter-provincial trade has declined while there have been massive investments in roads, railways and airport facilities. This is a startling fact. Trade economists have long noticed a home bias in trade patterns, i.e., domestic residents tend to buy from each other much more than they do from foreigners. A study on the inter-provincial trade in Canada reveals that its internal trade about 20 times its trade with the 30 states in the United States—the states Canadian provinces traded with most intensively.[4] Canada and the United States are two very similar countries on economic, political, and linguistic dimensions that should facilitate trade between them and yet internal trade in Canada still exceeds external trade by a wide margin.

FDI/CAPITAL FORMATION RATIO

A good relevant measure of China's openness to FDI is not the absolute size of FDI but FDI normalized by the size of the host economy. Countries vary in their economic and market size and the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1990 was much larger than the Chinese FDI but the US economy is roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States is less "dependent" on FDI than China is even though the absolute size of FDI flows into the United States is much greater.

A common measure of the relative size of FDI is the "FDI/capital formation ratio," given by the amount of FDI inflows in 1 year divided by the total fixed asset investments made by foreign and domestic firms in the same year. (In the paragraphs below, I use the term, FDI dependency, to refer to this ratio.)

Table 1.—Measures of capital inflows: Foreign loans, actual foreign direct investment (FDI), and contractual alliances, 1979–1999

		Amount (US$100 million)			Percentage shares of total capital inflows			Actual FDI inflows as a percentage share of fixed asset investments (percent)[2]	
	Total	Foreign loans	Actual FDI inflows	Contractual alliances[1]	Foreign loans	Actual FDI inflows	Contractual alliances[1]	Of Fixed-asset investments by all firms	Of Fixed asset investments by non-state firms
1979–1982	124.57	106.90	11.66	6.01	85.82	9.36	4.82		
1983	19.81	10.65	6.36	2.80	53.76	32.10	14.13	0.88	2.63
1984	27.05	12.86	12.58	1.61	47.54	46.51	5.95	1.60	4.52
1985	46.45	26.88	16.61	2.96	57.87	35.76	6.37	1.92	5.65
1986	72.57	50.14	18.74	3.69	69.09	25.82	5.08	2.07	6.21
1987	84.52	58.05	23.14	3.33	68.68	27.38	3.94	2.27	6.41
1988	102.27	64.87	31.94	5.46	63.43	31.23	5.34	2.50	6.86
1989	100.59	62.86	33.92	3.81	62.49	33.72	3.79	2.90	7.97
1990	102.89	65.34	34.87	2.68	63.50	33.89	2.60	3.69	10.90
1991	115.55	68.88	43.66	3.01	59.61	37.78	2.60	4.15	12.36
1992	192.03	79.11	110.07	2.85	41.20	57.32	1.48	7.51	23.52
1993	389.60	111.89	275.15	2.56	28.72	70.62	0.66	12.13	30.81
1994	432.13	92.67	337.67	1.79	21.44	78.14	0.41	17.08	39.18
1995	481.33	103.27	375.21	2.85	21.46	77.95	0.59	15.65	34.35
1996	548.04	126.69	417.26	4.09	23.12	76.14	0.75	15.10	31.81
1997	587.51	120.21	452.57	14.73	20.46	77.03	2.51	15.04	31.66
1998	579.36	110.00	454.63	14.72	18.99	78.47	2.54	13.25	28.27
1999	526.60	102.12	403.19	15.18	19.40	76.60	2.88	11.20	24.10
2000	594.50	100.00	407.10	17.71	16.80	68.50	2.98	10.30	20.60
2001	496.80		468.80	18.40		94.40	3.70	10.50	19.50
2002	550.10		527.40	21.30		95.90	3.87	10.10	

Source: State Statistical Bureau, China Foreign Economic Statistical Yearbook 2000 (Beijing, China Statistics Press, 2000). Statistics for 2000, 2001 and 2002 are from http://www.moftec.gov.cn/moftec—cn/tjsj/wztj/wztj—menu.html and EIU.

[3] (World Bank 1994).

[4] The finding was reported in (McCallum 1995), as quoted in (Ghemawat 2000).

Notes:
[1] Contractual alliances refer to asset leasing, compensation trade, and product processing.
[2] Fixed asset investments refer to purchases of new plants, property, and equipment made by both domestic and foreign firms in a given year. All the figures include investments made by FIEs.

Column (3) of Table 1 presents three different measures of the relative FDI size during three periods in the 1980s, 1990s and the 2001–2002 period. The three periods represent different phases of continuous FDI liberalization, as briefly summarized in the table. Column (3a) uses the fixed asset investments undertaken by all firms, including foreign firms, as the denominator. Column (3b) includes only the fixed asset investments by nonstate firms, that is, collective firms, FIEs, and domestic private firms. Column (3c) includes the fixed asset investments made by private firms and FIEs. One noticeable trend is the sharp rise in the FDI/capital formation ratio beginning in 1992. When we use the fixed asset investments undertaken by all firms, including FIEs, the ratio rose from 4.2 percent in 1991 to 7.5 percent in 1992. In 1994, the ratio reached 17.1 percent. Column (3b) shows a more rapid increase in the FDI/capital formation ratio when FDI is normalized by investments made by nonstate firms.

State-owned enterprises (SOEs) account for a large portion of fixed asset investments. Since the investment activities of SOEs are heavily influenced by the government, it is more appropriate to compare the level of investment activities of foreign firms with that of nonstate domestic firms. Nonstate firms, including FIEs, are more market-driven and are subject to harder budget constraints compared with the SOEs. As the Hungarian economist Janos Kornai points out, SOEs are afflicted with an "investment hunger" and are prone to over-investing regardless of the market demand for their products (Kornai 1980). Thus, it is more meaningful analytically to compare the investment behavior of FIEs with other nonstate firms. Between 1993 and 1997, FDI accounted for over 30 percent of the fixed asset investments made by nonstate firms in each year and during the same period, on average, FDI accounted for about 53 percent of the fixed asset investments made by domestic private firms and FIEs. There is no question that FDI is a significant source of investment financing in China.

Table 2 presents data on FDI/capital formation ratios in China and a number of other countries to provide a comparative perspective. The data are broken down by three periods, 1986–91, 1992–98, and 1999–2000. China's FDI dependency varied during these three periods. Compared with other countries in the table, it was initially low in the first period; it rose to a very high level in the second period; and it began to decline to a moderately high level in the third period.

Table 2.—Relative FDI Size, Macroeconomic Developments, and Business Environment, Various Years

Countries	Annual average FDI flows/gross fixed capital formation, all firms ratios (nonstate fixed asset investments only), percent			Gross domestic savings rate, 1994–97 (percent)	Current account balance/GDP, 1994–97 (percent)	Business environment for foreign investors		
	1986–91	1992–98	1999–2000			Rank in terms of ease of foreign acquisitions, 1996 (out of 46 countries)	Business environment rank, 1996–2000 (out of 60 countries)	Corruption perception rank, 1997 (out of 52 countries)
China	2.9 (8.6)	13.1 (27.9)	10.6 (21.5)	41.8	2.7	41	44	41
Philippines	6.6 (8.1)	8.3 (10.2)	7.6 (9.4)	15.5	−8.5	40	35	40
Indonesia	2.3 (3.4)	5.4 (8.9)	−13.7 (−22.7)	33.5	0.0	37	46	46
Thailand	5.5 (6.5)	5.6 (7.2)	11.9 (17.6)	38.0	−6.3	42	30	39
Malaysia	14.7 (22.8)	16.9 (24.3)	22.1 (30.3)	40.0	−0.8	43	24	32
Taiwan	3.6 (4.3)	2.2 (2.7)	11.8 (14.2)	[1]25.6	[1]−2.7	39	21	31
Korea	1.3 (1.6)	1.2 (2.0)	8.1 (10.7)	35.7	−1.8	46	29	34
Singapore	37.6 (49.7)	22.9 (30.3)	24.2 (32)	50.9	16.4	30	6	9
Brazil	1.6 (2.1)	7.7 (9.0)	27.6 (33.9)	20.1	−0.8	29	38	36
Mexico	8.3 (10.9)	13.5 (17.1)	10.7 (15.6)	21.4	0.5	28	34	47
India	0.3 (0.5)	2.2 (3.4)	2.1 (2.5)	21.2	−2.6	35	45	45
United States	6.5 (7.7)	6.9 (8.1)	15.8 (18.3)	15.6	−1.6	19	1	16
Canada	5.3 (6.1)	9.3 (10.6)	33.6 (38.6)	20.4	1.7	32	5	5
United Kingdom	13.6 (16.3)	13.5 (15.6)	41.9 (54.7)	14.7	−0.9	10	4	14

Table 2.—Relative FDI Size, Macroeconomic Developments, and Business Environment, Various Years—Continued

Countries	Annual average FDI flows/gross fixed capital formation, all firms ratios (nonstate fixed asset investments only), percent			Gross domestic savings rate, 1994–97 (percent)	Current account balance/GDP, 1994–97 (percent)	Business environment for foreign investors		
	1986–91	1992–98	1999–2000			Rank in terms of ease of foreign acquisitions, 1996 (out of 46 countries)	Business environment rank, 1996–2000 (out of 60 countries)	Corruption perception rank, 1997 (out of 52 countries)
Russia		2.0 (2.2)	9.1 (10.5)	27.7	4.3	45	53	49
Poland	0.01 (0.6)	13.1 (16.0)	20.6 (23.7)	16.7	−1.7	31	31	29

Note: [1] 1994 only.

Sources: FDI data are from United Nations Conference on Trade and Development (1998), United Nations Conference on Trade and Development (1999), United Nations Conference on Trade and Development (2000), and United Nations Conference on Trade and Development (2001). Private investment , savings and resource balance data are from the World Bank, World Development Report, various years and World Bank (1995a). For Taiwan, the source is Asian Development Bank (1995). The measure of ease of foreign acquisitions is based on a survey conducted by the International Institute for Management Development in Switzerland. Respondents were asked to rate countries according to a 10-point scale. A perfect score, 10, is given to countries that do not impose any restrictions on foreign acquisitions and 0 is given to countries where foreigners may not acquire control. The data are reported in International Institute for Management Development (1996). The business environment rank is a broader measure devised by the Economist Intelligence Unit. The country ranks for the 1996–2000 period are reported in ''Business Environment Scores and Ranks'' (2001). The corruption perception rank is devised by Transparency International; the 1997 data are reported on http://www.gwdg.de/?uwvw, accessed on October 23, 2001.

Between 1992 and 1998, on average, FDI flows into China accounted for about 13 percent of the gross capital formation of all firms annually. This ratio is one of the highest among the countries in the table, even compared with countries traditionally considered to be very FDI-dependent, such as countries in Southeast Asia. As pointed out earlier, even though the United States attracted a greater amount of FDI, the relative importance of FDI in the United States, at 6.9 percent during the 1992–98 period, was far smaller than it was in China. Compared with other Asian economies, China was less dependent on FDI in the 1980s, but its FDI dependency was among the highest in the region in the 1990s. China's FDI/capital formation ratio during the 1992–98 period was lower than that in Singapore and Malaysia, but much higher than that in Indonesia, Thailand, and the Philippines. The standard wisdom is that China is more similar to the Southeast Asian countries than it is to Korea, Taiwan, and Japan in terms of FDI dependency. That is true, but in fact China was among the most highly FDI-dependent economies in Asia during much of the 1990s. This is also the case if one uses gross domestic product (GDP), not fixed asset investment, to normalize FDI inflows.[5] (China's FDI/GDP ratio is high whether one uses the official exchange rate or the purchasing power parity rate.[6]) The claim that China is highly dependent on FDI does not at all hinge

[5] (Urata 2001) presents the FDI inflow/GDP ratios for nine Asian economies (China, Hong Kong, Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore, and Thailand) between 1986 and 1997. From 1986 to 1991, China ranked between No. 4 and No. 7 among these nine economies. From 1992 to 1997, China consistently ranked either as No. 2 or No. 3 most dependent on FDI, behind Singapore and, sometimes, Malaysia. Take 1995 as an example. In that year, China's FDI/GDP ratio was 5.1 percent, compared to 2.2 percent for Indonesia, 2.0 percent for Philippines, and 1.2 percent for Thailand. (It was 4.8 percent for Malaysia and 8.5 percent for Singapore.) The choice of 1995 was not arbitrary. Because FDI flows can fluctuate more than GDP, I chose a medium ratio for China rather than either the highest or the lowest ratio. In 1993 and 1994, China's FDI/GDP ratio was high, at 6.4 percent and 6.2 percent, respectively, compared to 4.9 percent in 1997. The year 1997 probably should not be used as well because the Asian financial crisis might have adversely affected FDI flows into the Southeast Asian countries. The FDI/GDP ratios are from (Urata 2001).

[6] As is well known, purchasing power parity (PPP) exchange rates can vary from official exchange rates by a wide margin and, depending on which exchange rates are adopted, the FDI dependency ratios will differ dramatically. An additional source of complications is that extremely different purchasing power parity exchange rates exist. Even when a purchasing power parity rate on the high end is used, as in World Development Report 1996, China is still more dependent on FDI than many other countries, albeit at a smaller magnitude of difference. The FDI/PPP-based GNP ratio in 1994 was 0.78 percent for Asia as a whole and 0.81 percent for the industrial countries. At the same time, it was 1.13 percent for China, thus making China about as dependent on FDI as Canada (1.25 percent), France (1.46 percent), Australia (1.46 percent), and Portugal (1.07 percent). It was more dependent on FDI than the United States (0.69

on benchmarking China against traditionally small recipients of FDI, such as Japan and Korea.[7]

China's FDI dependency, in a comparative perspective, is all the more striking if one takes into account the substantial investment roles of SOEs in China. As already pointed out, SOEs—subject to softer budget constraints compared to nonstate firms—are prone to over-invest. It is reasonable to expect a country with substantial public sector investments to have a lower FDI/capital formation ratio. For this reason, China's high FDI/capital formation ratio—inclusive of investments by SOEs—compared with other countries with a far smaller public sector is powerful evidence of the substantial role of FDI in the Chinese economy. Another way to illustrate the same point is to derive a FDI/capital formation ratio net of investments by public sector entities. This is indicated by the bracketed numbers in column (1b) of Table 2. By this measure, China's FDI dependency was the second highest among all the countries represented in the table. During the 1992–98 period China's FDI/capital formation ratio net of public sector investments was 27.9 percent, after Singapore (30.3 percent) but higher than Malaysia (24.3 percent).

In the 1999–2000 period, that is, column (1c) of Table 1.2, China's FDI dependency declined compared with many countries in the table. A major factor was the rapid and sudden surge in FDI dependency among the advanced developed countries, such as the United States, the United Kingdom, and Canada, and developing countries, such as Brazil, Korea, and Thailand. It should be stressed that this sudden rise in FDI dependency constituted a substantial deviation from earlier dependency levels in these countries, suggesting that a number of country- and period-specific developments may have contributed to this outcome.[8]

What is also interesting is that since China's WTO accession, in 2001 and 2002, FDI has continued to decline as a source of investment financing for the Chinese economy. FDI/capital formation ratio was 10.5 percent in 2001 and 10.1 percent in 2002. This echoes the argument that I laid out at the very beginning of this statement, i.e., a very important reason for China's unusual openness to foreign trade and FDI is in fact a result of substantial inefficiencies of China's economic system. WTO accord and other policy measures implemented by the Chinese government since the late 1990s have alleviated some of these inefficiencies and therefore have actually reduced China's dependency on FDI. My own view is that in the long run the role of FDI is only going to decline in the Chinese economy as internal allocation of financial resources continues to improve.

FDI VIS-À-VIS CROSS-PROVINCIAL INVESTMENTS

I pointed out before that the Chinese trade with each other less than they trade with foreigners. There is also a similar investment dynamic here. Some Chinese provinces depend on FDI to a far greater extent than they do on each other as a source of investment funds. Take Guangdong province as an example. In 1992, Guangdong invested about 2.5 percent of its total investments in other provinces while other provinces' investments amounted to 1.7 percent of total investments in Guangdong. In the same year, FDI accounted for 31.7 percent of Guangdong's investments, far surpassing both Guangdong's export of capital to other regions and its import of capital from other regions.[9] In monetary terms, the 2.5 percent of outward investments in other provinces amounted to 399 million dollars. To put this number in perspective, in 1993, firms based in tiny Macao—known more for its casinos than its computers and for its gangs than for its garment making—invested

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percent), Japan (0.03 percent), Italy (0.21 percent), and the United Kingdom (0.98 percent). These data are reported in (Li and Lian 1999).

[7] Other researchers have also noted China's high FDI dependency. Francoise Lemoine (2000), in a detailed descriptive analysis of China's FDI, makes the following remark, "FDI capital stock represented 25 percent of China's GDP in 1998, a ratio almost comparable to that existing in smaller economies which were opened to international capital flows long before China . . ." Lemoine points out that on a per capita basis, China's FDI inflows appear to be low, compared to other Asian countries. In 1998, FDI stock per capita in China was only $160. This measure is highly questionable. On a per capita basis, China is low on many other fronts. To illustrate this point, by this measure, the war-torn Angola would be considered more attractive than China as an FDI host. In 1999, FDI stock per capita in that country was $537.

[8] It is likely that the huge mergers and acquisitions in the "new economy" sector of the advanced countries contributed to this rise in FDI dependency and that the financial crises in Korea, Brazil, and Thailand induced an increase in the type of FDI seeking opportunities related to financial distress in those economies. In Korea, for example, much of the FDI since 1998 went into the troubled financial industry. See (Huang and O'Neil-Massaro 2002). Of course, the financial crisis did not induce FDI in those countries where the crisis impaired political stability and economic growth prospects, as witnessed by the net outflow in Indonesia.

[9] Guangdong's investment figure is calculated from Table 2.6, (World Bank 1994, p. 52).

586.5 million dollars in China.[10] (Unfortunately, the more recent data on cross-provincial investments are not available. The consensus is that internal trade and investments increased somewhat in the late 1990s but still they are at a lower level compared with China's foreign trade and FDI.)

This outsized investment position held by foreign firms is by no means limited to Guangdong, a province which has wooed foreign investments particularly aggressively. Sichuan, an interior province traditionally isolated from the outside world, also depended more heavily on FDI than on investments from other provinces. In 1993, investments from other provinces came to represent 0.22 percent of Sichuan's total investments; foreign investments, however, represented 5.4 percent. The data compiled by the World Bank show that out of six provinces four on average relied more heavily on FDI than on investments from other provinces between 1985 and 1993. This is remarkable and it shows the outsized foreign investor position in the Chinese economy.

The geographic dispersion of FDI is something that many people do not understand, including Chinese officials and Western economists. For example, in a presentation at a National Bureau of Economic Research conference, Zhang Shengman, a Chinese Ministry of Finance official and a managing director at the World Bank, argued that China "must strive for a more desirable distribution of capital flows, both geographically (more to the interior) and sectorally (more to some service sectors, retailing, banking, insurance, etc.)."[11] Two researchers, Edward Graham and Erika Wada, in a study on FDI in China make the following observation, "[V]ast areas of China, including ones where much state-owned industry is located, have not been touched by FDI" (Graham and Wada 2001, p. 5). In recent years, the Chinese government has made FDI promotion a prominent component of its development strategy for the central and western provinces.

The data that are often cited to support the geographic concentration hypothesis is that Eastern China accounted for 84.5 percent of cumulative FDI between 1985 and 1991 and 87.3 percent between 1992 and 1998 (Gipouloux 2000). The problem with this view is that it relies on statistics on the percentage shares of FDI distributed among Chinese provinces. Recall, however, that during the 1990s China attracted an enormous amount of FDI and thus a small portion of FDI going to the interior provinces is still a significant number. According to statistics provided in Gipouloux's study, the interior regions of China accounted for about 13 percent of cumulative FDI inflows between 1992 and 1998. During this period cumulative FDI flows into China as a whole amounted to $242.3 billion. This means that the interior regions of China received $31.5 billion in FDI. To put this number in perspective, India's entire FDI inward stock, as of 1997, was only $11.2 billion. In addition, the poor, hinterland provinces of China absorbed either more than or about the same level of FDI as some of the star economies in Latin America in the 1990s. As of 1997, the FDI inward stock for Argentina was $36 billion and it was $25.1 billion for Chile.[12]

In 1995, the average FDI/capital formation ratio for 14 interior and western provinces was 4.9 percent; if investments by SOEs are excluded, the ratio was 14.9 percent.[13] The 4.9 percent figure puts these provinces above Taiwan (2.2 percent), Korea (1.2 percent), India (2.2 percent), and Russia (2.0 percent). (All the numbers refer to the 1992–98 period.) The 14.9 percent figure, that is, FDI normalized by investments of nonstate firms, would make China's interior and land-locked provinces No. 6 out of the 15 economies represented in Table 2 (excluding China). While she argues that the FDI distribution pattern in China is uneven, in her own paper, Lemoine (2000, p. 30) shows that FDI stock/GDP ratio for interior provinces was 10.9 percent in 1998. To put this number in perspective, in 1998, the FDI stock/GDP ratio for North America was 10.5 percent, for Central and Eastern Europe, 12.9 percent, and for South, East and South-East Asia, 10.5 percent.[14]

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[10] To clarify, China bans FDI in casinos and thus Macao's large investment position cannot be attributed to this source of its competitive advantage.

[11] See (Zhang Shengman 1999), p. 181.

[12] The data on India, Chile, and Argentina are provided in (United Nations Conference on Trade and Development 1998), Annex Table B.3.

[13] There are 16 provinces that are classified as interior or western provinces. No FDI data are available for two of these provinces—Inner Mongolia and Tibet. The remaining 14 provinces are: Shanxi, Anhui, Jiangxi, Henan, Hubei, Hunan, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang. The figures are calculated on the basis of data provided in (State Statistical Bureau 1996).

[14] These figures are from (United Nations Conference on Trade and Development 2000), Annex Table B. 5.

THE UBIQUITOUS PRESENCE OF FOREIGN FIRMS ACROSS CHINESE INDUSTRIES

FIEs, firms established through FDI, can be found in far more industries in than other countries. Empirical research on FDI has found that a general pattern of industry distribution of FDI is that FDI is concentrated in just a few industries. For example, in a survey article Newfarmer and March find that over 80 percent of foreign subsidiaries in Mexico and Brazil were in industries with four-firm concentration ratios exceeding 50 percent. Similar concentration patterns of foreign firms were found in Peru, Chile, Colombia, and Malaysia.[15] According to Bruce Kogut, FDI in Central European countries exhibited a similar pattern. Foreign firms were found in only a few industries, such as autos, consumer products, and telecommunications. And the investing firms were familiar ones, such as ABB, Coca-Cola, and Proctor & Gamble.[16]

FDI patterns in China are quite different in that FDI is present rather evenly across different industries. Data are available for FDI from Hong Kong broken down by industries for the 1990s for a number of countries on a consistent basis. These data show substantially less concentration patterns in China. For example, in Malaysia, the top three industries with the most Hong Kong FDI accounted for 58.9 percent of the total materialized Hong Kong FDI in 1994. In the same year, on an approval basis, the top three industries in Indonesia with the most Hong Kong FDI accounted for 77.6 percent of the total Hong Kong FDI.[17] But in China, the top three industries, electronics, plastic products, and textiles, only accounted for 46.7 percent of total Hong Kong FDI as of 1993. The lower concentration ratio means that FDI is also present in many other industries in China. In fact among the 28 manufacturing industries, none received more than 10 percent of total FDI as of the mid–1990s. The highest share was 9.6 percent in the electronics and telecommunications industry. The textile industry followed, at 8.9 percent.

FOREIGN CONTROLS OF EXPORT MARKETING

It follows naturally that the large FDI inflows would have led to a substantial role of FIEs in the Chinese economy. This is demonstrated in Table 3. As of 1995, FIEs controlled over half of China's manufactured exports, or 51.2 percent. Because FIEs are restricted in the primary industries and FIEs are not allowed to be pure trading corporations, their export share of total exports is smaller; in 1995, it was 31.5 percent.[18] By 2002, FIEs accounted for over 50 percent of Chinese exports. Nationwide, FIEs dominate the export channels in a number of industries, such as electronics and telecommunications, garments and footwear, leather products, printing and record pressing, cultural products, and plastics, etc. In 1995, they accounted for over 60 percent of Chinese exports in these industries.[19] Nor are sales shares insignificant as well. In four industries, the sales shares of industrial FIEs exceeded 50 percent of industry sales and accounted for 21 percent of all manufactured sales in 1995. This share grew to 32.1 percent by 2000.[20]

Again, it is easier to illustrate the substantial role of FIEs in the Chinese economy by benchmarking China against other economies. FIEs in China have established a far more dominant position in export production than their counterparts in Taiwan, when Taiwan was in a comparable stage of development as China in the 1970s. As of the mid-1970s, FIEs in Taiwan accounted for only 20 percent of Taiwan's manufactured exports.[21] The share of FIEs in China's exports not only exceeds that of Taiwan but of other Asian countries as well during comparable stages of development. Two authors, Seiji Naya and Eric Ramstetter, provide some of the most complete statistics. Their paper shows that, except for Singapore, where multinational corporations (MNCs) have traditionally dominated domestic firms, no other

[15] This research is summarized in (Moran 1998, p. 23).

[16] Central Europe exhibits a familiar pattern of oligopolistic rivalry among foreign investors. FDI may disturb national oligopolies, although, as Kogut points out, multinational corporations prevail in industries characterized by oligopoly. See (Kogut 1996).

[17] These data are calculated on the basis of Table 4.2 and Table 4.3 in (Yeung 1998).) In the text, I use data from the 1970s because the industrial groupings are most similar to those in China, thus facilitating a direct comparison. The materialized amount may differ from the approval amount if an investor fails to invest the pledged amount of capital.

[18] Export data for 1995 are from (State Statistical Bureau 1996). For some unknown reason, the Chinese government no longer released disaggregated FIE export data, broken down by economic sector or industry, after 1995.

[19] The source of data is Third Industrial Census. The firms covered by the Third Industrial Census are firms with an "independent accounting system." This raises a number of data issues. See the appendix to this chapter for a detailed explanation of a number of data issues involved in using Third Industrial Census.

[20] Calculated from data provided in (State Statistical Bureau 2001).

[21] The export share data for Taiwan come from (Ranis and Schive 1985).

Southeast Asian country came close to the 51 percent share of manufactured exports claimed by Chinese FIEs.[22] In Korea, between 1974 and 1978, foreign firms accounted for 24.9 percent of manufactured exports. In Thailand, in the 1970s, the share ranged from 11 to 18 percent, and in 1984 it was 5.8 percent.

Table 3.—Export Shares of FIEs in Total Exports of Three Economies: China, Taiwan, and Indonesia

(In percent)

	China (1995)	Taiwan (1980)	Indonesia (1995)
Labor-intensive industries	Garments and footwear: 60.5	Garments and footwear: 5.7	Garments and footwear: 33
	Leather and fur products: 73.2.	Leather and fur products: 9.6	Leather and related products: 19.7
	Furniture: 75.1	Lumber and bamboo products: 2.7.	Furniture: 14.0
Capital or technology-intensive industries.	Electronics and electrical appliances: 83.4.	Electronics and electrical appliances: 50.5.	Electric, measuring, and photographic apparatus: 78.8
	Paper and paper products: 53.4.	Pulp paper and paper products: 4.5.	Computers and parts: 91.8
	Chemical materials and products: 31.6.	Chemicals: 34.9	Machinery and vehicle parts: 86.1
			Paper and paper products: 29.8
			Chemical materials: 42.3
Manufacturing industries	51.2	20.6	29.0

Sources: Chinese data are from Office of Third Industrial Census (1997) and Taiwanese data are from Ranis and Schive (1985, Table 2.12, p. 109). Indonesian data are unpublished and were provided to the author by the Indonesian government through the kind assistance of Timothy S. Buehrer and Lou Wells. Professor Lou Wells generously provided English translations of the Indonesian text.

Table 3 presents FIE shares of total exports in three economies, China (1995), Taiwan (1980), and Indonesia (1995). The table breaks down export data by labor-intensive and capital- (or technology-) intensive industries. Two patterns emerge. One is that the FIE shares of exports in labor-intensive industries are much higher in China than in Taiwan or Indonesia. For example, garment and footwear FIEs accounted for 60.5 percent of exports in China, but only 5.7 percent in Taiwan and 33 percent in Indonesia. FIEs similarly dominated exports in leather and furniture in China to a far greater extent than they did in Taiwan and Indonesia. The second pattern is that in capital- or technology-intensive industries, FIEs in China and Indonesia dominated exports to a far greater extent than they did in Taiwan. This is a more common pattern in developing countries, not only because the local capabilities in modern industries are low, but because the goods being produced are intermediate inputs, such as electronic components. Japanese firms, for example, have invested heavily in Southeast Asia to produce electronic components, which are re-exported to the parent firms.[23] Ownership arrangements are more common for this type of goods because often the only way for local producers to gain access to the supply chain of the MNCs is to be part of the MNC system. (In contrast, garments, footwear, and furniture are final goods or near final goods).

FOREIGN CONTROL OF ASSETS

The significant position of FIEs in the Chinese economy raises a natural question about control. Corporate control is a complicated concept but the simplest measure is the investor's share of the equity ownership. The higher the share, the more control the investor is said to have since equity ownership is usually an indicator of how decisionmaking power is apportioned among investors, through, for example, the number of board seats one can appoint. Since many FIEs in China are JVs, decisionmaking is shared among Chinese and foreign investors. The allocation of decisionmaking power is determined on the basis of their respective shares of equity ownership.

Foreign firms have established majority controls over FIEs in most industries. Only in 7 out of 28 manufacturing industries are foreign firms found to have an average aggregate minority equity position, that is, the total equity value owned by

[22] All the data on Korea and the Southeast Asian countries are from (Naya and Ramstetter 1988). Data for later years are more difficult to find, except for the export production data by FIEs in Indonesia cited in the text.

[23] A good discussion on this topic is found in (United Nations Conference on Trade and Development 1998), especially pp. 209–221.

the foreign firms is less than 50 percent of the industry sum of FIE equity.[24] State-owned monopolies or oligopolies are typically found in those industries where foreign firms have minority stakes. The tobacco industry is probably the most illustrative example. It is run by a single government agency, the China Monopoly Bureau of Tobacco Industry, which operates integrated production from tobacco procurement to cigarette making. But even in this heavily monopolistic industry, the combined equity stake of foreign firms already reached 46.9 percent by 1995. While foreign firms have been able to make inroads into industries explicitly reserved for the most powerful government corporations, nonstate indigenous firms have been largely excluded.

Another characteristic is that foreign majority equity controls seem unrelated to some of the well-known features of these industries. Foreign majority controls span both labor-intensive industries, such as garments, footwear, and leather products, and capital-intensive industries, such as chemicals, machinery, and instrument manufacturing. This across-the-board foreign equity control contrasts with the Taiwanese pattern. In Taiwan foreign firms have dominant equity positions in certain industries, such as garments and footwear (71.8 percent), lumber and bamboo products (75.7 percent), and leather and fur products (79.6 percent). But in quite a number of industries, they are mere minority investors (such as nonmetallic minerals, chemicals, and the machinery industry).[25] Thus, in China not only do foreign firms have larger equity positions and thus putatively greater corporate control over FIEs, their controls are uniform across industries.

WHY CHINESE ECONOMY IS "UNUSUALLY" OPEN?

Chinese economy should be considered "unusually" open in two ways. First, it appears to be more dependent on foreign trade and FDI even compared with many market-oriented, developed economies. Second, Chinese economy is unusually open in that some sectors of the Chinese economy are more open to foreign investors than to domestic private businesses. In fact, one can go further by arguing that precisely because Chinese economy is quite closed to the domestic private sector it has become more open to foreign investors as a result. I have elaborated on this point in greater detail in my recently published book, Selling China (New York: Cambridge University Press, 2003). Let me explain this point here.

CONSTITUTIONAL STATUS: FIES AND DOMESTIC PRIVATE FIRMS

Western investors often view China's legal system as the single most important deterrent to FDI inflows. In 1997, a survey conducted by the European Commission of 200 European companies operating in China stated that "incomprehensible or unpredictable rules and legislation remain the principal obstacle to investment in China." Looking forward, foreign investors are not very optimistic about the prospects of rule of law in China. In a 1997 survey on 22 foreign firms active in China, only 4 of them expected the rule of law to become widely accepted in China while most of the respondents viewed rule of law to be a goal of the government but not reality of the Chinese economy and society.[26]

The usual question in the studies on government regulation is whether the regulatory environment is "business-friendly." The answer to this question in the Chinese context is easy: It is not. The Wall Street Journal and Heritage Foundation rated China in 2002 as a "mostly unfree" economy (given a bright yellow color to join the likes of India, Cambodia, Romania and Bulgaria) even after more than 20 years of remarkable economic reforms. According to the aft-cited study, "China's legal and regulatory structure remains so riddled with contradictory internal (*neibu*) unpublished guidelines and exceptions that foreign businesses say progress in the rule of law has actually slowed in recent years." (The Heritage Foundation and The Wall Street Journal 2002)

Many of these analyses, while not factually wrong, miss one of the most fundamental features of the Chinese economy. While it is widely recognized that Chinese legal system functions poorly, the relevant question is whether the Chinese legal system functions more poorly for some firms than for other firms. In particular, we want to know whether the legal system consistently favors one type of firms over others in accordance with the nationality of the firm. Here China is quite unique

[24] Most of the industries, including the more capital-intensive industries, have a large number of enterprises. For example, there were 1,409 FIEs in the transport equipment sector in 1995. The high foreign equity share is not the result of large equity positions of a few foreign firms.

[25] The Taiwanese data are reported in (Ranis and Schive 1985).

[26] Quoted in (Lubman 1998).

among many countries in that the government has created a legal framework that is on balance more favorable to foreign firms than to domestic private firms.

On balance, the legal treatment of FIEs has been far superior than that accorded to domestic private firms (although inferior to that of state owned enterprises or SOEs). The most remarkable example concerns the constitutional treatment of FIEs and domestic private firms. China's Constitution, adopted in 1982, only 6 years after the Cultural Revolution, clarified and offered protection to the legal status of foreign enterprises operating in China (Article 18). Foreign enterprises were permitted "to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations . . ."[27] Article 18 also swore to protect their "lawful rights and interests."

While Article 12 of the Constitution prohibited "appropriation or damaging of State or collective property," no such a commitment was made about the property rights of private enterprises. Remarkably, more than 25 years after reforms began, the Constitutional treatment of domestic private firms remains inferior to that of foreign firms investing in China. The Chinese State has yet to make a Constitutional commitment not to nationalize or expropriate the assets of domestic private investors without "due cause and compensation," the right foreign investors got in 1982.

One example is the low political and legal status of private businesses. Article 11 of the 1982 Constitution acknowledged the property rights of self-employed private businesses—termed the individual economy—but it did not acknowledge the property rights of other types of private firms. In 1988, Article 11 was amended to add a clause that the State permitted private firms and that the State was to protect their "lawful rights and interests," but the amendment also subordinated the private sector to "a complement to the socialist public economy."[28] This meant that private firms were allowed entry only in industries where they did not pose a competitive threat to the SOEs, but the strength of property rights protection provided to private businesses lagged far behind that for SOEs and even for FIEs.

In more recent years, the treatment of domestic private businesses began to improve. In March 1999, Article 11 was amended again and the private economy was to be a "component" of the Chinese economy. This meant, at least nominally, that private firms, FIEs, and SOEs were to have an equal status. In 2001, the former president of China, Jiang Zemin, welcomed private entrepreneurs to join the communist party. In 2003, the Chinese officials were discussing a Constitutional amendment—to be adopted in 2004—that would specifically pledge protection of property rights to private businesses. (For texts of relevant clauses of China's Constitution, see Table 5.)[29]

Table 5.—Evolving Constitutional provisions regarding private and foreign property rights in China, 1982–1999

Constitutional provisions	Adopted at the Fifth Session of the Fifth National People's Congress, December 4, 1982	The amendment adopted at the Seventh National People's Congress at its First Session, April 12, 1988	The amendment adopted at the third session of the Ninth National People's Congress, March 1999
Article 11 ...	"The individual economy of urban and rural working people, operating within the limits prescribed by law, is a complement to the socialist public economy. The State protects the lawful rights and interests of the individual economy..	Article 11 of the Constitution shall include a new paragraph, which reads: "The State permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy..	Article 11 of the Constitution is amended to: "The non-public sector of the economy comprising self-employed and private businesses within the domain stipulated by law is an important component of the country's socialist market economy.

[27] For an extensive analysis, see (Gelatt 1983).

[28] The text of the 1982 Constitution and the 1988 amendment is found in, Constitution of the People's Republic of China, (Beijing, Foreign Languages Press, 1994).

[29] See Anonymous, "Amendments to the Constitution of the People's Republic of China," Beijing Review, May 3–9, 1999.

Table 5.—Evolving Constitutional provisions regarding private and foreign property rights in China, 1982–1999—Continued

Constitutional provisions	Adopted at the Fifth Session of the Fifth National People's Congress, December 4, 1982	The amendment adopted at the Seventh National People's Congress at its First Session, April 12, 1988	The amendment adopted at the third session of the Ninth National People's Congress, March 1999
	The State guides, assists and supervises the individual economy by administrative control.''.	The State protects the lawful rights and interests of the private sector of the economy, and exercises guidance, supervision and control over the private sector of the economy.''.	The State protects the legitimate rights and interests of the self-employed and private businesses. The State exercises guidance, supervision and management over the self-employed and private businesses.''
Article 18 ...	''The People's Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations in accordance with the law of the People's Republic of China.. All foreign enterprises, other foreign economic organizations as well as Chinese-foreign joint ventures within Chinese territory shall abide by the law of the People's Republic of China. Their lawful rights and interests are protected by the law of the People's Republic of China.''.		

Source: Constitution of the People's Republic of China, Beijing, Foreign Languages Press, 1994 and ''Amendments to the Constitution of the People's Republic of China,'' (1999) Beijing Review, May 3–9.

FINANCIAL BIASES

As China's pace of integration into the world economy accelerated, some influential economists in China argued that domestic private firms were often regarded as inferior compared to other firms in the Chinese economy. A 2000 report by the Chinese Academy of Social Sciences concluded the following:[30]

Because of long-standing prejudices and mistaken beliefs, private and individual enterprises have a lower political status and there are numerous policy and regulatory discrimination and limitations. The legal, policy, and market environment is unfair and inconsistent.

For a long time, there was a severe lending bias against private firms in favor of the SOEs.[31] Until 1998, the four big state-owned commercial banks, which controlled most of the banking assets, were specifically instructed to lend to SOEs only. (The Bank of China could lend to FIEs.) Lending to nonstate firms by the four commercial banks remained a minuscule portion of their loan portfolios. Among the nonstate firms, FIEs were able to access the Chinese banking system more readily than the domestic private firms. It should be pointed out, however, that the primary function of China's banking system is to serve the financial needs of the SOEs.

China's licensing policy also discriminated against private firms. In 2002, a top legislator, Tian Jiyun wrote in People's Daily that over 60 industrial sectors were open to FDI but only 40 industrial sectors were open to investments by domestic private firms. Foreign trade licensing was also biased against domestic private

[30] Institute of Industrial Economics of Chinese Academy of Social Sciences, China's Industrial Development 2000, (Beijing: Economic Management Press, 2000).

[31] The phenomenon of a lending bias on the part of the Chinese banking system in favor of SOEs was widely documented. See Ronald I. McKinnon, "Financial growth and macroeconomic stability in China, 1978–1992: Implications for Russia and other transitional economies," Journal of Comparative Economics, 18, 1994, pp. 438–469, and Nicholas R. Lardy, China's unfinished economic revolution, (Washington, DC, Brookings Institution, 1998).

firms. While the FIEs could directly export and import products within their business lines and many SOEs could export directly, until 1999, most private firms were required to export through the official state-owned trading corporations.

EFFECTS OF DISCRIMINATION AGAINST DOMESTIC PRIVATE SECTOR

One of the effects of discriminating against domestic private firms while maintaining a relatively open stance toward FDI is that foreign firms have managed to establish substantial market and industry positions, as documented in the previous section of this statement. In comparison, truly private firms—defined as those controlled by private entrepreneurs completely independent of the government—were still quite small. Excluding self-employed business units, truly private industrial firms only accounted for 9.2 percent of the value of the gross industrial output as of 2001. Industrial FIEs, in contrast, accounted for 28.5 percent.[32]

A related effect is that the business environment, while admittedly difficult for many foreign firms in China, is in fact even more difficult for domestic private firms. We have a subjective measure—the perceptions of foreign and domestic firms of the constraints of China's business environment—to illustrate this point.

Our perception data come from the World Business Environment Survey (WBES). The survey was implemented in 2000 and it focused on perceptions of factors external to the firm. Many dimensions of business environment were surveyed, ranging from perceptions of the national business environment as shaped by local economic policy; governance to the perceptions of regulatory, infrastructural and financial impediments and public service quality. The survey was done on roughly 100 firms in each of some 80 countries. For the first time, China agreed to be a part of this type of surveys.

Very fortunately, the survey breaks down firms by their foreign and domestic ownership. Table 6 presents the average response scores given by foreign and domestic firms to a number of questions measuring regulatory burdens, rule of law, helpfulness of the government, and general business constraints. The minimum score is 1, indicating a good business environment perception; the maximum score ranges from 4 to 6, indicating a bad business environment perception. (The survey includes firms with ownership ties to the government. I have excluded them from Table 6 in order to demonstrate the contrast between FIEs and domestic private firms.)

Table 6.—The average response scores given by foreign and domestic private firms on business environment in China, 2000

	Foreign firms	Domestic private firms
Business regulations: 1=no obstacle; 4=major obstacle	1.79	1.90
Labor regulations: 1=no obstacle; 4=major obstacle	1.62	1.70
General constraint—taxes and regulations: 1=no obstacle; 4=major obstacle	1.86	2.17
Confidence in judicial system today: 1=fully agree; 6=fully disagree	2.59	2.77
Quality of courts: 1=very good; 6=very bad	3.15	2.97
Changes in laws and regulations: 1=completely predictable; 6=completely unpredictable	3.37	3.15
Helpfulness of central government today: 1=Very helpful; 5=Very unhelpful	3.00	3.02
Helpfulness of local government today: 1=Very helpful; 5=Very unhelpful	2.76	2.62
General constraint—financing: 1=no obstacle; 4=major obstacle	2.93	3.48
General constraint—corruption: 1=no obstacle; 4=major obstacle	1.93	2.13

Source:World Bank Business Environment Survey.

In some areas, domestic private firms feel more constrained than foreign firms; in other areas they feel less constrained. In general, domestic firms are constrained in the area of regulations. They gave a higher score for business and labor regulations and on general constraint on taxes and regulations. In general, foreign firms are less satisfied with China's legal system than domestic firms, although domestic firms appear to have less confidence than foreign firms in China's judicial system. Foreign and domestic private firms rate government similarly in terms of helpfulness of the government, although domestic private firms view local governments as more helpful. On the two critical measures of a business environment, financing and corruption, domestic private firms indicate more constraints than foreign firms and on the issue of financing constraint, substantially so.

[32] Data are from the State Statistical Bureau, *Zhongguo tongji nianjian 2002* [China Statistical Yearbook 2002], (Beijing, *Zhongguo tongji chubanshe, 2002*).

CONCLUDING REMARKS

Let me conclude by coming back to a point I made at the very beginning of this statement. China's WTO implementation is not a narrowly legal issue but should be judged against the general economic background of the country. Chinese economy is in fact "unusually" open to foreign firms not because it has very liberal FDI policies but because it has very illiberal policies toward the domestic private sector. A thorough WTO implementation may in fact help ease some of the constraints on domestic private sector and thus may contribute to a decline of the role of foreign trade and FDI in the Chinese economy. In fact, this is already happening since China's WTO accession as the government is trying to create a more equal playing field for foreign firms and for domestic private firms.

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PREPARED STATEMENT OF HON. JAMES A. LEACH, A U.S. REPRESENTATIVE IN CONGRESS FROM IOWA, CHAIRMAN, CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

SEPTEMBER 24, 2003

This morning the Congressional-Executive Commission on China convenes to examine U.S.-China trade relations in the context of the development of the rule of law in China. We have asked our distinguished panelists to share their expert views with us on the Chinese trade policies that have a negative affect on U.S. businesses and whether or not the Chinese pursuit of such policies can be characterized as "unfair" under international norms and standards.

The Chinese economy has experienced unprecedented growth in recent years. Between June 2002 and June 2003, Chinese exports grew by 32.6 percent. Foreign direct investment into China grew to $52.7 billion in 2002, pushing China past the United States and for the first time making it the number one target for foreign investment. While these growth trends began long before China's entry into the WTO in December 2001, increased access to the largest consumer market in the world and sweeping market reforms will only increase China's attractiveness as a manufacturing base. Under these circumstances, China's robust growth may well continue for many years.

But along with the benefits of WTO membership come responsibilities. The United States, together with all of China's trading partners, has been monitoring very carefully China's compliance with its obligations under the WTO accession protocol. In June 2002, the Commission held a hearing to look prospectively at China's ability to comply with its rule of law-related commitments. At that time, and according to the assessment of many experts throughout the first year of China's WTO membership, the consensus was that it was "too early to tell" whether China would be able to comply, and that China's performance in the second year after accession—when China had a chance to demonstrate its efforts to meet its obligations-would tell us more.

As we near the end of "Year 2," we ought to look again at how China is faring as a member of the international trading community. Measuring WTO compliance is one of the few empirical tools we have to assess the development of the rule of law in China: China's commitments to change its laws and policies are legally binding, and they have been embraced by the political leadership. Most trade experts agree that China has done very well in reducing tariffs, as required by the WTO terms of accession. Such explicit obligations are easier to meet, and China's trading

partners may determine more easily whether or not China is in compliance with them.

The WTO obligation to remove non-tariff barriers, however, is much harder to fulfill and also harder to assess. For example, indirect subsidization of protected industries may contravene WTO requirements. Also, failure to meet rule of law obligations, including transparency, equal application of the laws, the institution of judicial review, and national treatment for foreign goods and investors, may in effect operate as non-tariff barriers. Such barriers may unfairly protect domestic industries, and it may be that the United States should take specific steps to seek to break down these barriers. We must first, however, seek to understand the nature of these violations, and then we can determine the course the United States should take to seek redress. We hope today's testimony will help give us a sense of what the United States could and should ask China to do.

One potential consequence of WTO noncompliance may be exacerbation of the U.S.-China bilateral trade deficit. The trade imbalance has become an issue of great concern to Americans in the past year, especially in communities dependent on manufacturing for economic survival. Although American concerns about the losses of the U.S. manufacturing base are legitimate, understanding what the bilateral deficit means and what its root causes are is crucial to finding the solution to the problems caused by the loss of manufacturing jobs. For this reason, we look forward to hearing testimony on how the United States should approach the U.S.-China trade imbalance.

Some argue that China's undervaluation of its currency, the yuan, is a leading cause of the bilateral imbalance and also may be a violation of the WTO Subsidies Agreement. Others say that critics overstate the impact of the yuan's value, and that China's currency policy complies with its international obligations. Beyond the WTO, the Commission is keen to understand whether China's currency policies, or any other of its domestic policies, are "unfair" in the sense that they contravene the standards that China is reasonably expected to uphold as member or the international community and a partner in the international economic system.

We look forward to hearing the views of our witnesses about how well China is complying with its WTO commitments, and whether China may or may not be conforming to other international standards and norms that may affect American businesses and the American economy. We hope all the panelists will recommend steps that the U.S. Government should take to address the outstanding issues in U.S.-China trade relations.

PREPARED STATEMENT OF HON. CHUCK HAGEL, A U.S. SENATOR FROM NEBRASKA, CO-CHAIRMAN, CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

SEPTEMBER 24, 2003

The U.S.-China relationship is the most important relationship our country will have over the next 50 years. Managing this relationship will be as complicated as it is critical. We must get it right.

China's economic and political influence is growing, and few problems in the Asia-Pacific region can be solved without its cooperation. The United States and China are finding new ways to cooperate, from achieving stability in Northeast Asia, to intelligence sharing in the war against terrorism, to joint operations in battling international trafficking in narcotics. Despite this, we should not be surprised that we will continue to have serious differences with China. China must improve its human rights practices. It must improve its proliferation safeguards. And it must live up to its WTO commitments. Each of these issues, if left unresolved, will impact our overall relationship.

China's current trade and economic policies demand close scrutiny because they impact both U.S. national security policy and U.S. jobs. Trade remains the biggest common denominator between our two countries and it offers the mutual benefits necessary to build a stable relationship for the future. However, U.S. exports to China have failed to keep pace with imports and it is in the best interests of both countries to adjust this imbalance. This will require China meeting its obligations for full, effective and uniform application of WTO commitments at the national, provincial, and local levels. China must also develop a reasonable timetable to achieve full convertibility of the yuan. The question of whether a currency is under or overvalued, and by how much, cannot be settled in the absence of a free market.

China has undertaken many of its obligations under the WTO accession process, particularly in the area of tariff reductions. However, as the American Chamber of Commerce in China recently noted in its 2003 White Paper, "the WTO honeymoon

period is over." China is failing to implement its own laws protecting intellectual property rights. It has not taken the concrete regulatory steps necessary to open specific industries and sectors to competition. Progress on soybeans has been particularly troubling. U.S. exporters have faced Chinese government policies that are as unclear as they are complicated, and most recently U.S. soybean exports have been disrupted by non-science-based phytosanitary restrictions. China's efforts to meet its WTO commitments to implement tariff rate quotas for bulk agricultural products have been equally unsatisfactory. China must move forward in meeting each of these obligations.

China understands that the political stability of Asia is closely linked to an expanding global economy, and this to the continued development of a fair and open trading system. China and the United States share this important goal. Building a cooperative agenda will not grow out of unrealistic expectations of what both sides can achieve in the short term, but instead out of the clear-eyed realization that we have a mutual interest in developing a common approach to a wide range of bilateral, regional and global issues in this new century. China's willingness to work with us in the coming weeks, months, and years will tell us much about whether China and the United States will move forward in building a deeper and more relevant relationship.

PREPARED STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

SEPTEMBER 24, 2003

Thank you, Chairman Leach and Co-Chairman Hagel, for holding this hearing. It comes at an important time.

While the United States has lost millions of manufacturing jobs in the last few years, China's exports of manufactured products to the United States have soared. We're on track for the U.S. trade deficit with China to exceed $100 million for the second year in a row. In these circumstances, it is not surprising that a rising chorus of voices is demanding that something be done about China.

One thing that we can do is to look carefully to make sure that China is properly implementing its WTO obligations. We are now approaching the end of the second year of China's WTO membership. This provides a good opportunity for us to take stock of how China is performing as a full member of the world trading system.

It is my own sense that China has come a long way toward implementing the commitments it made in its WTO accession agreement, but it still has a long way to go. Problems that could have been chalked up to glitches or "startup" difficulties in the first year of China's WTO membership are now, in some cases, being seen as evidence of a lack of resolve on the part of the Chinese government to meet its obligations.

TRANSPARENCY IN REGULATIONS

Perhaps chief among these is a widespread lack of transparency in licensing and permitting regulations, both in their drafting and their application. This makes it very difficult for U.S. companies to operate in China.

Although China has passed many of the laws required under its WTO commitments, it has in many cases not issued any implementing regulations. This is true for various sectors of the economy, including the financial services, distribution, and automotive sectors.

When regulations are issued, they are frequently issued without allowing sufficient time for industry participants to comment. And they often impose barriers, such as excess capitalization requirements, that appear designed to discourage foreign businesses from entering the market at all.

TARIFF RATE QUOTAS

Another problem of great concern to me deals with China's failure to allocate its tariff rate quotas ("TRQs") for agricultural products in accordance with its accession agreement. China has allocated uneconomic amounts to some quota recipients. It also does not disclose the identity of those receiving allotments as it had agreed to do. This makes it difficult for U.S. companies to identify potential customers. Further, import permits are effectively being used to maintain import controls on U.S. agriculture commodities and meat exports, important products for my home State of Montana.

This is a longstanding problem. In July, I urged USTR to begin preparing a WTO case on Chinese TRQs. Since then, I have been told that there may have been some

movement toward a resolution on this issue. I hope the witnesses can inform us about any progress on China's TRQs.

INTELLECTUAL PROPERTY

China's attitude toward intellectual property is also great cause for concern. Counterfeiting of U.S. trademarks is rampant. Copyright piracy is a thriving industry in China. The piracy rate for movies, video games, and music approaches 90 percent. This is clearly unacceptable. China needs to do more to protect intellectual property.

I am also concerned about regulations China is currently developing for a government procurement law China enacted earlier this year. Those regulations would require the government to purchase only domestic goods and services, including software.

VALUE-ADDED TAX

Another issue deals with China's value-added tax ("VAT"). In some cases, China applies its VAT to discriminate against imports. Officials may exempt locally produced goods while assessing the full VAT on imported goods, or they may rebate the VAT on goods made and sold in China.

CURRENCY

The final issue I want to raise deals with China's currency. China pegs its currency at a fixed exchange rate that economists estimate is undervalued by anywhere between 15 to 40 percent against the U.S. dollar. This artificially depresses the prices of Chinese exports and hurts the competitiveness of U.S. manufacturers.

When I was in Cancun a few weeks ago for the WTO ministerial, I had the opportunity to discuss this issue with Chinese Commerce Minister Lu Fuyuan. Minister Lu made clear that China appreciates the need to revalue its currency for its own internal reasons, but he added that this won't happen for several years.

We should continue to impress upon the Chinese the many reasons why it should allow the value of its currency to be determined according to market principles. As an interim step, China should immediately revalue its currency significantly or begin to set its exchange rate values in reference to a basket of foreign currencies—rather than simply pegging it to the dollar. This is an issue that I will continue to follow very closely.

CONCLUSION

I've chosen to highlight just a few of the problems in China's WTO compliance and trade with the United States. There are others.

I hope the witnesses will discuss these issues in their testimony. In particular, I hope they will address what steps the United States has taken or plans to take to respond to these concerns.

I worked hard to ensure China's accession to the WTO, and I will work hard to ensure that China abides by its WTO commitments. I look forward to working with my colleagues and the Administration to make sure that China plays by the rules. Thank you.

PREPARED STATEMENT OF HON. MARCY KAPTUR, A U.S. REPRESENTATIVE IN CONGRESS FROM OHIO

SEPTEMBER 24, 2003

Mr. Chairman, I am pleased that the Commission is meeting today to discuss our trade relations with China. As an original member of this Commission, I believe it is vital that we look at the record trade deficits we have with our number one trading partner.

First, as I examine the list of panelists, I must express some concern about its makeup. There is plenty of representation for the Administration, Big Business, and academia. Unfortunately, one of the most essential voices has been silenced—that of the workers. There is no representation of the working men and women from the United States or China. We hardly can understand the full spectrum of issues related to trade relations without hearing from the people on the factory floor or those who work in the fields. To ignore this is inexcusable.

The Commission should ensure that we always start with the facts. One of the most noteworthy details is our escalating trade deficit with China. Mr. Chairman, I ask that the following be inserted into the record:

China Trade Deficit

(In billions)

1999 (Before PNTR)	−$68
2000 (PNTR passed in May)	−83
2001	−83
22002	−103
2003 (Through May)	−65

When I began my career in Congress, the discussion was much the same—only we were speaking about Japan. Record trade deficits, questions about currency valuation and market access were the hot topics. Little has changed 21 years later. Several administrations and legislative proposals later, little has changed because Japan is not a free market. It is a managed market. We have tried to open the Japanese market. In 1983, less than 3 percent of Japan's market consisted of automobiles or auto parts from international sources. In 2003, it is the same. It does not matter if it is 150 yen to the dollar or 98.

What makes us think that China is any different? It too is a managed market. The only way we will be able to measure success is through the trade deficit. Are we buying more or selling more?

Over the last decade, the U.S. has lost millions of manufacturing jobs. Fifty cents of every U.S. farm dollar comes from Federal subsidies. Something is fundamentally wrong with the trade accounts and it is evident at the highest policy levels. The United States is essentially cashing out its wealth.

One such wealth is the job of the working American. I call on the various departments who are supposed to be overseeing our trade policy—United States Office of the Trade Representative, Department of Commerce, and the Department of Labor—to invest some of their resources in workers here and in China. Let us as a Commission, as Members of Congress, travel to China to see what is really going on.

In my area of the country, Huffy Bicycle had 2,000 people employed in Ohio manufacturing the best bicycles in America. All of those workers have now lost their jobs. They were earning a living wage. They had health benefits. They produced a fine product.

Those Huffy bicycles are now made in China. This Commission should visit that factory. The Administration should travel with us to see the working conditions. Instead of a living wage they earn starvation wages. I cannot imagine the type of "health plan" with which the Chinese workers were presented.

The expatriate companies are trading on the exploitation of workers. They are trading on environmental conditions where they are leaving cesspools around the earth. Until we challenge that, the U.S. will never balance these trade accounts. It is well-known that these imbalances are not sustainable. We need to be realistic and, in turn, create a realistic trade plan.

I encourage the USTR and the Departments of Commerce and Labor to set a target of reducing our trade deficit. I am not going to suggest that we turn a deficit into a surplus overnight. However, we must stem this tide of record trade deficits. Simply working toward a lower level this year than last would be a step in the right direction. This is not an unattainable task. It is one upon which our economic future depends and the least the Administration could do for working families.

Prepared Statement of Hon. Sander M. Levin, a U.S. Representative in Congress From Michigan

SEPTEMBER 24, 2003

Today's hearing is called, "Is China Playing by the Rules?" The answer to that question is clearly and unfortunately, "No." China has not yet come into full compliance with its WTO commitments. I am not talking about the commitments that China's WTO agreement allows it to phase in; I am speaking of the commitments China agreed to fully implement either immediately or within its first 2 years of WTO accession. China has not yet fulfilled many of these commitments; in other cases, China has taken steps that indicate a clear intention to undermine its WTO market access commitments.

In many areas, China has made substantial progress and it is important to acknowledge that progress. At the same time, halting progress is not what the U.S. bargained so hard for. The United States is fully living up to its WTO commitments vis-à-vis China—evidenced by total Chinese imports to the United States of $125

billion. The massive trade deficit with China of over $100 billion—the single largest U.S. bilateral trade deficit—reminds us that we cannot be satisfied with mere "progress" from China. We need complete, unconditional, and timely compliance from China with its WTO commitments.

Last year, many in Congress, the business community and the Administration were willing to take a "pressure and patience" approach, giving China time to make all the myriad changes to law and practice necessitated by WTO accession. Indeed, we still must realize the massive restructuring that China's legal system, even China's society, is undergoing by virtue of China's membership in the WTO. Had China made concerted, uninterrupted, and steady progress toward WTO compliance, that approach may have continued.

Unfortunately, the Chinese government's lack of attention to the rule of law has infected its approach to WTO compliance. The Chinese government has often taken arbitrary and inconsistent approaches to its WTO obligations; it has acted in non-transparent ways and refused to publish the laws and regulations with which businesses must comply; in some cases, the Chinese government has retained for itself a large measure of discretion, creating an uncertain environment and leaving companies unclear as to what the rules are.

Moreover, China has blocked effective use of the specially negotiated annual Transitional Review Mechanism (TRM) of China's WTO compliance. In most cases, China has refused to provide written answers to questions submitted by other WTO Members; in many other cases China has refused to provide any answers or given vague and evasive answers. China has denied consensus on efforts to make the TRM process more effective and has even gone so far as to call countries that raised concerns about China's WTO compliance "troublemakers," reminiscent of language China uses in the domestic context to silence dissent.

Listed below are just some of the continuing problems with China's WTO accession:

- Transparency.—Article X of the WTO requires countries to publish in advance all laws, regulations, etc. affecting the import, sale, distribution, transportation, insurance, warehousing, inspection, etc. of imports. China has made some progress, but still does not uniformly publish laws and regulations applicable to trade, meaning U.S. firms often do not know what the rules are, whether the rules have changed, or how to comply with the rules.
- Additionally, even when China does publish regulations, these are often very vague and leave government authorities wide discretion, which is applied in an unpredictable manner and in ways preferential to Chinese-based manufacturers.
- Quota Administration and Import Licensing.—China's administration of its quotas and import licensing rules has made it very difficult for companies in China to import products from the United States and for U.S. exporters to find Chinese buyers. For instance, China announced increases in quotas on automobiles and auto parts, but there is little public information on what companies received quota allocations or how those quotas may be exercised. In some cases, allegations have arisen that China has awarded import quotas in economically unviable amounts, to domestic producers of competing products or state-owned companies that have no intention of importing, and to companies that have committed to use the import only as an input for products to exported.
- Discriminatory taxes.—China continues to impose discriminatory taxing schemes on various "border trade" products and other products, including integrated circuit products. The former clearly violates MFN and the latter clearly violates China's national treatment obligations.
- Continuing Limits on Trading Rights.—China only allows some companies to import and export products ("trading rights"). China strictly controls which companies have such rights, and uses this control as a tool to restrict imports. China agreed to broaden trading rights, but it has not yet implemented its commitments and appears to be imposing new conditions on these rights.
- Distribution Rights.—Even if U.S. products are imported via trading rights, China imposes limits on who may distribute products. China uses these distribution rights as a way of keeping out U.S. imports. China is obligated by its WTO commitments to expand distribution rights, but has failed to take all the steps necessary to do this.
- Intellectual Property.—Intellectual property piracy is rampant throughout China. China has made progress to improve its legal framework, but continues to have a poor record of enforcement, suggesting a lack of will from the government.
- Technical Barriers to Imports.—In some sectors China has issued new technical product and safety regulations that are sui generis and appear to be designed to help keep out imports.
- Currency Undervaluation.—Article XV(4) of the GATT prohibits WTO members from using "exchange action" to "frustrate the intent of the [GATT] provisions."

China has allowed kept its currency pegged to the dollar at a rate that economists agree is substantially undervalued, effectively providing a "currency tariff" on U.S. exports to China and a "currency subsidy" to Chinese imports to the United States.

- Auto Financing and Other Financial Services Limited by Unreasonably High Capital Requirements.—China agreed to open its auto financing market to U.S. firms upon its WTO accession. China has not complied with this obligation 2 years later. Its draft regulations contained unreasonably high capital requirements that are not justified by any prudential or regulatory rationale and it has yet to issue final regulations. Other U.S. financial services providers face similar market access barriers.
- Auto Industrial Policy Paper.—In April of this year, China issued a draft "Development Policy for Auto Industry" setting forth Chinese government industrial policy for the automotive industry. This paper is admittedly light on specifics, but the following concepts in the paper are or could be problematic:

  —Mentions "macroeconomic steering" to achieve the objective of becoming "one of the major automobile manufacturing countries in the world by 2010."

  —Indicates numerous points in which the state will standard-less control over competitive decisions of automobile manufacturers in China through various approval mechanisms, which could be used as way of forcing technology transfer or limiting allowable imports.

  —Includes plans to restrict the number of ports through which imported autos may enter.

  —Requires that imported and domestically produced autos be distributed through separate sales outlets.

  —Sets export targets of components and parts of 40 percent by 2010.

  —Suggests that technical requirements will be used as a way of keeping out imports and simple assembly operations.

  —Indicates that the state will provide subsidies for the development of auto electronics.

  —Dangles for foreign firms the possibility of a "strategic alliance" with a domestic firm that would have 10 percent market share in exchange for technology and know-how transfer.

  —Suggests availability of state-subsidized capital for the domestic auto industry.

  —Indicates firms will have to produce domestically in China at least 5 years before they can enter new product lines or open new factories in other cities.

  —Indicates that preferential treatment will be given to plants set up for export.

  —Indicates that state subsidies will be provided to develop stronger domestic steel plate for autos manufacturing capacity and machine tools and dies.

  —Sets goal that Chinese companies will provide designs for half of all domestically produced cars by 2010.

  —Indicates that quotas and creative application of customs duties will be used to keep out auto part imports.

Compliance with WTO obligations cannot be a one-way street. It is time for the USTR to take the lead and aggressively demand China's complete, unconditional, and timely compliance with all of its WTO commitments. USTR must use every avenue to push China to come into compliance with its WTO obligations. Last year, the USTR allowed China to block effective use of the TRM, and it looks as if this year, USTR is resigned to accept continuing uncooperativeness by China as a fact of life. The TRM was designed to help avoid larger confrontations over China's WTO compliance. If China continues to defy the WTO and frustrate the TRM process, USTR should begin a campaign of cases against China in WTO dispute settlement.

American manufacturers are justifiably concerned that Chinese imports have free access to our market, while China has refused to open its market more fully to U.S. goods. It is time to start taking concrete action to remedy the imbalance.