CHINA

TRADE SUMMARY

The U.S. goods trade deficit with China was $201.6 billion in 2005, an increase of $40 billion from $161.9 billion in 2004. U.S. goods exports in 2005 were $41.8 billion, up 20 percent from the previous year. Corresponding U.S. imports from China were $243.5 billion, up 24 percent. China is currently the 4th largest export market for U.S. goods.

U.S. exports of private commercial services (i.e., excluding military and government) to China were $7.2 billion in 2004 (latest data available), and U.S. imports were $5.6 billion. Sales of services in China by majority U.S.-owned affiliates were $3.8 billion in 2003 (latest data available), while sales of services in the United States by majority China-owned firms were not available in 2003 ($321 million in 2002).

The stock of U.S. foreign direct investment (FDI) in China in 2004 was $15.4 billion, up from $11.5 billion in 2003. U.S. FDI in China is concentrated largely in the manufacturing, wholesale, and mining sectors.

Since joining the WTO in December 2001, China has taken steps to implement its numerous WTO commitments. With most of China's key commitments scheduled to be phased in fully by December 2004, this past year provided a first critical glimpse at what to expect of China as a WTO member with its full range of commitments in place. At this point, however, China's implementation work is still incomplete. While China has made important progress in implementing specific commitments and in adhering to the ongoing obligations of a WTO member, there are still serious problems in some important areas, especially in the enforcement of intellectual property rights (IPR). Many of the shortfalls in China's WTO compliance efforts seem to stem from China's incomplete transition from being a state-planned economy. China has not yet fully embraced the key WTO principles of market access, non-discrimination and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent. Although China implemented some key reforms, it continued to use an array of industrial policy tools in 2005 to promote or protect favored sectors and industries, and these tools at times collide with China's WTO obligations.

The Administration utilized high-level engagement, expert-to-expert discussions and WTO mechanisms to address the problems that arose and, in particular, initiated a comprehensive new strategy for obtaining improvements in China's IPR enforcement. Many of these efforts culminated in a meeting of the Joint Commission on Commerce and Trade (JCCT) in July 2005, co-chaired by Vice Premier Wu Yi on the Chinese side and Secretary of Commerce Gutierrez and United States Trade Representative Portman on the U.S. side. That meeting achieved measured progress on a range of concerns, but it fell short of realizing the many win-win outcomes of the previous JCCT meeting, held in April 2004. Nevertheless, China did agree to take several specific actions in support of its WTO commitment to significantly reduce IPR infringement levels, to initiate technical consultations with WTO members to accelerate its

efforts to join the WTO Government Procurement Agreement and to schedule telecommunications and insurance dialogues to discuss market access issues in those sectors.
While U.S. stakeholders generally hold the view that China's economic reforms have improved the climate for U.S. exporters and investors, serious challenges remain, and many U.S. businesses are still not able to maximize their opportunities in the Chinese market. Areas that continue to generate significant problems include inadequate enforcement of laws, particularly in the IPR area, industrial policies, services, agriculture and an overall lack of transparency in the regulatory environment.

In the IPR area, while China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR enforcement remains a major challenge. Building on its engagement with China at the April 2004 JCCT meeting, the United States took several aggressive steps in 2005 in an effort to obtain meaningful progress. First, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch" list and set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, which included the possible use of WTO mechanisms, as appropriate. The United States immediately began to pursue this strategy during the run up to the July 2005 JCCT meeting, and China subsequently agreed to take a series of specific actions designed to increase criminal prosecutions of IPR violators, improve enforcement at the border, combat piracy of movies, audio visual products and software, address Internet-related piracy and assist small and medium-sized U.S. companies experiencing China-related IPR problems, among other things. Because lack of transparency on IPR infringement levels and enforcement activities in China has hampered the United States' ability to assess the effectiveness of China's efforts to improve IPR enforcement since the April 2004 JCCT meeting, the United States also submitted a transparency request to China under Article 63.3 of the TRIPS Agreement in October 2005. The U.S. request, made in conjunction with similar requests by Japan and Switzerland, seeks detailed information from China on its IPR enforcement efforts over the last four years.

China has also increasingly resorted to industrial policies that limit market access by non-Chinese origin goods or rely on substantial government resources to support increased exports. The objective of these policies seems to be to support the development of Chinese industries by effectively mandating local content of products that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries. In 2005, examples of these industrial policies are readily evident. They include the issuance of regulations on automotive parts tariffs that discourage the use of imported parts, the telecommunications regulator's interference in commercial negotiations over royalty payments to intellectual property rights holders in the area of 3G standards, the pursuit of unique national standards in many areas of high technology that could lead to the extraction of technology or intellectual property from foreign rights holders, draft government procurement regulations mandating purchases of Chinese-produced software, a new steel industrial policy that calls for the state's management of nearly every major aspect of China's steel industry, continuing export restrictions on coke, and excessive government subsidization benefiting a range of domestic industries in China. Some of these policies may raise concerns with respect to China's WTO commitments in the areas of market access, national treatment, subsidies disciplines and technology transfer, among others.

In the area of services, concerns in many sectors remain, largely due to arbitrary and non-transparent policies, delays in the issuance of regulatory measures, and China's use of entry threshold requirements that exceed international norms. Indeed, Chinese regulatory authorities continue to frustrate efforts of U.S. providers of distribution, direct selling, franchising, insurance, construction and engineering, telecommunications and other services to achieve their full market potential in China.

In the area of agriculture, while the United States was able to reach agreement on and initial a Memorandum of Understanding in July 2005 to facilitate cooperation on animal and plant health safety issues and improved U.S. access to China's markets for agricultural commodities, agricultural trade with China remains among the least transparent and predictable of the world's major markets. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary (SPS) standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities.

Transparency concerns cut across sectors, as China's various regulatory regimes continue to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. Although China has taken steps to improve transparency across a wide range of national and provincial regulatory authorities, particularly at the Ministry of Commerce (MOFCOM), many other ministries and agencies have made less than impressive efforts to improve their transparency.

Overall, while China has a more open and competitive economy than 25 years ago, and China's WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled. The central government continues to implement industrial policies and protect noncompetitive or emerging sectors of the economy from foreign competition. In many sectors, import barriers, opaque and inconsistently applied legal provisions, and limitations on foreign direct investment often combine to make it difficult for foreign firms to operate in China. In addition, some ministries, agencies and government-sponsored trade associations have renewed efforts to erect new technical barriers to trade. Meanwhile, many provincial governments at times have strongly resisted reforms that would eliminate sheltered markets for local enterprises or reduce jobs and revenues in their jurisdictions, although they have also supported market access for other foreign investors that do not pose a threat to local vested interests.

If China is to complete the implementation of its WTO commitments and institutionalize market-oriented reforms, it will need to eliminate mechanisms that allow government officials to intervene in the Chinese economy in a manner that is inconsistent with market principles. Despite its remarkable transformation over the past quarter century, China continues to suffer from its command economy legacy. As a result, Chinese economic policy-making often operates in a way that prevents U.S. businesses from achieving their full potential in the China market. As U.S. expectations shift from the establishment of basic regulations and implementation of specific WTO commitments to measurable improvements in market access for U.S. products and services, there will be decreasing tolerance for Chinese efforts to protect domestic industries.

In early 2006, the Administration completed a USTR-led interagency "top-to-bottom" review of the United States' China trade policy. Recognizing the importance of the United States' trade relationship with China and the challenges that confront the United States in that relationship, the Administration issued a report concluding that the United States is entering an important new phase in its relationship with China. While U.S. trade policy for the past 20 years had been focused principally on encouraging market-based reforms and bringing China into the international trading system, the report explained that the end of China's transition period as a new WTO member was drawing near, and it recommended that U.S. trade resources and priorities should be readjusted to meet new challenges. Specifically, in addition to strengthening the United States' current focus on China's WTO compliance and adherence to international norms, the report urged that more focus be put on ensuring that: (1) the bilateral trade relationship offers more balanced opportunities and is equitable and durable; (2) U.S. trade policymaking is more proactive and informed by more comprehensive information regarding China's economic trends and developments and stronger coordination within the Executive branch and between the Executive and Congressional branches; (3) China participates more fully in the global trading system as a responsible trading partner; and (4) the U.S. remains an active and influential economic and trading power in the Asia Pacific region. Based on the results of the interagency review, the Administration committed to take a series of actions to help ensure that the United States is best positioned to meet its key China trade objectives. Among other things, the Administration committed: (1) to expand USTR's trade enforcement capacity; (2) to expand USTR's capability to obtain and process comprehensive, forward-looking information about the U.S.-China trade relationship; (3) to expand U.S. trade resources in Beijing; (4) to strengthen interagency coordination and the Executive-Congressional partnership on China trade; and (5) to increase coordination with other trading partners on China trade issues. The Administration also committed to strengthen, expand and increase the effectiveness of the U.S.-China dialogue on needed structural economic reforms and numerous specific issues, such as standards and SPS issues, China's subsidies practices, financial services, telecommunications services, labor, environmental protection, and transparency and the rule of law, among other issues.

IMPORT REGULATION

Prior to its WTO accession in December 2001, China restricted imports through high tariffs and taxes, quotas and other non-tariff measures, and restrictions on trading rights. Beginning in 2002, its first year in the WTO, China significantly reduced tariff rates on many products and the number of goods subject to import quotas, expanded trading rights for Chinese enterprises, and increased the transparency of its licensing procedures. Since then, China has continued to make progress by implementing tariff reductions on schedule, phasing out import quotas and expanding trading rights for foreign enterprises and individuals, although some serious problems remain, such as China's tariff treatment of imported automotive parts.

Trading Rights

Prior to its WTO accession, China restricted the types and numbers of entities with the right to trade. Only those domestic and foreign firms with trading rights could import goods into, or export goods out of, China. Restrictions on the type and number of firms with trading rights contribute to systemic inefficiencies in China's trading rights system and create substantial incentives to engage in smuggling and other corrupt practices.

Liberalization of China's trading rights system had been proceeding gradually since 1995. The pace accelerated in 1999 when MOFCOM's predecessor, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), announced new guidelines allowing a wide variety of Chinese firms with annual export volumes valued in excess of $10 million to register for trading rights. In August 2001, China extended this regulation to allow foreign-invested firms to export their finished products. Import rights of foreign-invested firms were still restricted to the importation of inputs, equipment and other materials directly related to their manufacturing or processing operations. Firms and individuals without trading rights, including foreign-invested firms with a manufacturing presence in China seeking to import products made outside of China, were required to use a local agent.

In its WTO accession agreement, China committed to substantial liberalization in the area of trading rights. Specifically, China committed to eliminate its system of examination and approval of trading rights and to make full trading rights automatically available to all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships, within three years of its accession, or by December 11, 2004, which was the same deadline for China to eliminate most restrictions in the area of distribution services. China further committed to expand the availability of trading rights pursuant to an agreed schedule during the first three years of its WTO membership.

Although China did not fully adhere to the agreed phase-in schedule in some instances, it has put in place a registration system implementing the required liberalization of trading rights, both for Chinese enterprises and for Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships. This liberalization is reflected in China's revised Foreign Trade Law, issued in April 2004 by the National People's Congress. It provides for trading rights to be automatically available through a registration process for all domestic and foreign entities and individuals, effective July 1, 2004, almost six months ahead of the scheduled full liberalization required by China's accession agreement. In June 2004, MOFCOM issued implementing rules setting out the procedures for registering as a foreign trade operator. U.S. companies have reported few problems with the new trading rights registration process, although China's slow progress in implementing related distribution services commitments has made these new rights less meaningful for some U.S. companies.

In December 2004, as required by its WTO accession agreement, China also ended its practice of granting import rights or export rights for certain products – steel, natural rubber, wools, acrylic and plywood – only to designated enterprises. Any domestic or foreign enterprise or individual can now trade in these products.

Consistent with the terms of China's WTO accession agreement, the importation of some goods, such as petroleum and sugar, is still reserved for state trading enterprises. In addition, for goods still subject to tariff-rate quotas such as grains, cotton, vegetable oils and fertilizers, China reserves a portion of the in-quota imports for state trading enterprises, while it committed to make the remaining portion (ranging from 10 percent to 90 percent depending on the commodity) available for importation through non-state traders. In some cases, the percentage available to non-state traders increases annually for a set number of years.

Meanwhile, China has not yet implemented its trading rights commitments insofar as they relate to the importation of books, newspapers and magazines. Under the terms of China's accession agreement, China's trading rights commitments apply fully to books, newspapers and magazines, as they are not among the products for which China reserved the right to engage in state trading. As a result, trading rights for books, newspapers and magazines should have been automatically available to all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals as of December 11, 2004. Nevertheless, China continues to wholly reserve the right to import books, newspapers and magazines to state trading enterprises.

China has also not yet implemented its trading rights commitments insofar as they relate to the importation of pharmaceuticals. Even though China's accession agreement creates no exception for pharmaceuticals, and trading rights should have been automatically available to foreign pharmaceutical companies as of December 11, 2004, China still requires foreign pharmaceutical companies to hire Chinese importers to bring their finished products into the country (and it also requires them to sell their finished products through Chinese wholesalers).

Import Substitution Policies

Throughout the 1990s, China gradually reduced formal import substitution policies. In its WTO accession agreement, China committed that it would not condition import or investment approvals on whether there are competing domestic suppliers or imposes other performance requirements. In anticipation of this commitment, China enacted legal changes in 2000 and 2001 to eliminate local content requirements for foreign investments. Under the prevailing rules, however, investors are still "encouraged" to follow some of the formerly mandated practices. Instances in which the Chinese Government has reportedly pursued import substitution or similar policies are described below.

Corporate Tax Deductions to Foreign-Invested Firms

The State Administration for Taxation (SAT) in May 2005 issued Circular No. 488/2005 that allows foreign-invested firms to deduct the costs of domestic-manufactured equipment from their corporate income taxes. According to the notice, equipment manufactured in China is eligible for the tax deduction but equipment assembled in China from imported parts is not eligible.

Automotive Parts

Before China's WTO accession, China's automobile industrial policy offered significant advantages for foreign-invested factories using high-levels of local content. In 2001, in anticipation of China's new obligations as a WTO Member, the State Economic and Trade Commission (SETC) issued Bulletin No.13, which provided that the preferential policy for

automobile localization rates would be cancelled upon China's WTO accession. However, U.S. automobile manufacturers reported that some local government officials continued to require local content and cited the old automobile industrial policy's standards. China also committed to issue a revised automotive industrial policy within two years of its WTO accession, or by December 11, 2003, but missed this deadline. In May 2004, China issued a new automobile industrial policy. It included provisions discouraging the importation of auto parts and encouraging the use of domestic technology. It also included a number of vague provisions, such as in the area of complete knocked-down automotive kits, whose implementation will warrant close scrutiny.

In 2005, China issued measures implementing the new automobile industrial policy. One problematic measure is the *Measures on the Importation of Parts for Entire Automobiles*, which was issued by the National Development and Reform Commission (NDRC) in February 2005 and became effective in April 2005. These new rules require manufacturers in China to register the parts they use in the assembly of new automobiles, and if the number or value of imported parts exceeds specified thresholds, China's General Administration of Customs will apply the tariff rate assessed a complete automobile on each of the various imported parts rather than the tariff rate applicable to an individual part. China's bound and applied tariff rates for complete automobiles are significantly higher than the tariff rates for imported auto parts. The new rules appear to improperly condition tariff treatment on local content and to result in the imposition of a tariff on automotive parts in excess of the bound rate.

Steel

China issued a new Steel and Iron Industry Development Policy in July 2005. Although many aspects of this new policy have not yet been implemented, it still includes a host of objectives and guidelines that raise serious concerns. For example, this policy appears to discriminate against foreign equipment and technology imports. Like other measures, this policy encourages the use of local content by calling for a variety of government financial support for steel and iron projects utilizing newly developed domestic equipment. Even more troubling, however, it calls for the use of domestically produced steel-manufacturing equipment and domestic technologies whenever domestic suppliers exist, apparently in contravention of the commitment in China's accession agreement not to condition the right of investment or importation on whether competing domestic suppliers exist.

Semiconductors

China's 10th Five-Year Plan calls for an increase in Chinese semiconductor output from $2 billion in 2000 to $24 billion in 2010. In pursuit of this policy, China has attempted to encourage the development of China's domestic integrated circuit (IC) industry through, among other things, discriminatory VAT policies. In particular, through a series of measures, China has provided for the rebate of a substantial portion of the 17 percent VAT paid by domestic manufacturers on their locally produced ICs. China, meanwhile, charged the full 17 percent VAT on imported ICs, unless they were designed in China. After bilateral meetings on this issue failed to yield a change in China's policy, in March 2004, the United States filed the first and to date only WTO case against China. In the ensuing consultations, China signaled its willingness

to discuss a possible resolution. In July 2004, the United States and China reached a settlement in which China agreed to immediately cease certifying new Chinese IC manufacturers or products as eligible for the VAT rebate and to issue the necessary regulations to eliminate the VAT rebate entirely by November 1, 2004, with an effective date no later than April 1, 2005. China also agreed to repeal the relevant implementing rules that had made VAT rebates available for ICs designed in China but manufactured abroad by September 1, 2004, with an effective date no later than October 1, 2004. China followed through on each of these agreed steps in a timely manner, and the two sides notified the WTO in October 2005 that their dispute had been satisfactorily resolved. Nevertheless, the United States continues to monitor closely new financial support that China is making available to its domestic producers for consistency with the WTO Subsidies Agreement's disciplines.

Fertilizer

In 2001, China began exempting all phosphate fertilizers except diammonium phosphate (DAP) from the VAT. DAP, a product that the United States exports to China, competes with other phosphate fertilizers produced in China, particularly monoammonium phosphate. Both the United States Government and U.S. producers have complained that China has employed its VAT policies to benefit domestic fertilizer production.

Telecommunications Equipment

There have been continuing reports of Ministry of Information Industry (MII) and China Telecom adopting policies to discourage the use of imported components or equipment. For example, MII has reportedly still not rescinded an internal circular issued in 1998 instructing telecommunications companies to buy components and equipment from domestic sources.

Tariffs and Other Import Charges

Under the terms of its WTO accession, China committed to substantial annual reductions in its tariff rates, with most of them taking place within five years of China's WTO accession. The largest reductions took place in 2002, immediately after China acceded to the WTO, when the overall average tariff rate fell from over 15 percent to 12 percent.

China's post-WTO accession tariff rates are "bound," meaning that China cannot raise them above the bound rates without "compensating" WTO trading partners, i.e., re-balancing tariff concessions or, in accordance with WTO rules, being subject to withdrawal of substantially equivalent concessions by other WTO members. "Bound" rates give importers a more predictable environment. China may also apply tariff rates significantly lower than the WTO-required rate, as in the case of goods that the government has identified as necessary to the development of a key industry. For example, China's Customs Administration has occasionally announced preferential tariff rates for items that benefit key economic sectors, in particular for the automotive, steel and chemical industries.

China's WTO accession commitments are having a dramatic effect on tariffs for many products of interest to the United States. As in prior years, China implemented its scheduled tariff

reductions for 2005 on schedule. These tariff reductions further increased market access for U.S. exporters in a range of industries, as China continued the process of reducing tariffs on goods of greatest importance to U.S. industry from a base average of 25 percent (in 1997) to 7 percent over a period of five years, running from January 1, 2002, while it made similar reductions throughout the agricultural sector (see the Agriculture section below). The reductions made on January 1, 2005, involved a range of sectors, including motor vehicles and motor vehicle parts, office machinery, large appliances, furniture and chemicals, and contributed to another significant increase in U.S. exports, which rose approximately 17 percent from January through September 2005, when compared to the same time period in 2004.

In one of its more significant tariff initiatives, China continued its participation in the Information Technology Agreement (ITA), which requires the elimination of tariffs on semiconductors and semiconductor manufacturing equipment, computers and computer parts, software, telecommunications equipment, computer-based analytical instruments and other information technology products. China began reducing and eliminating these tariffs in 2002 and continued to do so in the ensuing years, achieving the elimination of all ITA tariffs on January 1, 2005, as tariffs on ITA products dropped to zero from a pre-WTO accession average of 13.3 percent. U.S. exports of ITA goods continued to perform well in 2005, as they were projected to exceed $5 billion by the end of the year, although they did decrease by 12 percent from January through September 2005, when compared to the same time period in 2004.

China also continued its timely implementation of another significant tariff initiative, the WTO's Chemical Tariff Harmonization Agreement. U.S. chemical exports covered by this agreement increased by 36 percent from January through September 2005 and were projected to reach $5.8 billion by the end of the year, well above 2004's healthy total of $4.7 billion.

Meanwhile, exports of some bulk agricultural commodities have increased dramatically in recent years, particularly cotton and wheat, while exports of soybeans continued to perform strongly, totaling $1.2 billion for the first nine months of 2005. Exports of forest products such as lumber performed strongly, increasing by 26 percent for the first nine months of 2005, with a projected year-end total of $477 million. Fish and seafood exports, after having increased from $119 million in 2001 to $135 million in 2002, and then to $176 million in 2003 and $258 million in 2004, rose by another 41 percent in the first nine months of 2005 and were projected to reach $363 million by the end of the year. Meanwhile, exports of consumer-oriented agricultural products increased by only 4 percent from January through September 2005, when compared to the same period in 2004, although they were still projected to exceed $500 million by the end of the year.

However, China still maintains high duties on some products that compete with sensitive domestic industries. For example, the tariff on large motorcycles will only fall from 60 percent to 45 percent. Likewise, most video, digital video and audio recorders and players still face duties of around 30 percent. Raisins face duties of 35 percent.

Tariff Classification

Chinese customs officers have wide discretion in classifying a particular import. While foreign businesses might at times have benefited from their ability to negotiate tariff classification into

tariff categories with lower import duty rates, lack of uniformity makes it difficult to anticipate border charges.

Recent foreign and joint venture auto manufacturing entrants to the Chinese market complain about disparate treatment under tariff classification rules. They are less able than domestic manufacturers and the early joint venture entrants to assemble cars with locally manufactured components, and their knock-down kits imported for assembly in China are more likely to be classified as complete vehicles than are the kits imported by domestic manufacturers and the early joint venture entrants.

Customs Valuation

In January 2002, shortly after acceding to the WTO, China's Customs Administration issued the *Measures for Examining and Determining Customs Valuation of Imported Goods*. This measure addressed the inconsistencies that had existed between China's customs valuation methodologies and the Agreement on Customs Valuation.

The Customs Administration subsequently issued the *Rules on the Determination of Customs Value of Royalties and License Fees Related to Imported Goods*, effective July 2003. This measure was intended to clarify provisions of the January 2002 measure that address the valuation of royalties and license fees. In addition, by December 11, 2003, China had issued a measure on interest charges and a measure requiring duties on software to be assessed on the basis of the value of the underlying carrier medium, meaning, for example, the floppy disk or CD-ROM itself, rather than based on the imputed value of the content, which includes, for example, the data recorded on a floppy disk or CD-ROM.

Nevertheless, China has not uniformly implemented these various measures. U.S. exporters continue to report that they are encountering valuation problems at many ports. For example, even though the January 2002 and July 2003 measures provide that imported goods normally should be valued on the basis of their transaction price, meaning the price the importer actually paid, nearly four years later, many Chinese customs officials are still improperly using "reference pricing," which usually results in a higher dutiable value. In 2005, China appeared to continue its efforts to eliminate the use of "reference pricing," although it still occurs at many ports.

In addition, some of China's customs officials are reportedly not applying the provisions in the January 2002 and July 2003 measures as they relate to software royalties and license fees. Following their pre-WTO accession practice, these officials are still automatically adding royalties and license fees to the dutiable value (for example, when an imported personal computer includes pre-installed software), even though China's July 2003 measure expressly directs them to add those fees only if they are import-related and a condition of sale for the goods being valued. While some improvement appears to have taken place with regard to the valuation of royalties and license fees since the issuance of the July 2003 measure, that measure has not led to uniform, WTO-consistent implementation by China's customs officials in this area.

Beginning in 2004, U.S. exporters also complained about the Customs Administration's handling of imports of digital media that contain instructions for the subsequent production of multiple copies of products such as DVDs. The Customs Administration has been inappropriately assessing duties based on the estimated value of the yet-to-be-produced copies.

Rules of Origin

In September 2004, nearly three years after China acceded to the WTO, the State Council finally issued the regulations intended to bring China's rules of origin into conformity with WTO rules for import and export purposes. These regulations took effect on January 1, 2005, although necessary implementing rules are still being drafted. Nevertheless, importers have not reported problems stemming from inappropriate application of rules of origin.

Border Trade

China's border trade policy continues to generate MFN and other concerns. China provides preferential import duty and VAT treatment to certain products, often from Russia, apparently even when those products are not confined to frontier traffic as envisioned by Article XXIV of GATT 1994. China addressed some of these concerns in 2003 when it eliminated preferential treatment for boric acid and 19 other products. Nonetheless, it appears that large operators are still able to take advantage of border trade policies to import bulk shipments across China's land borders into its interior at preferential rates. In addition, U.S. industry reports that China continues to use border trade policies to provide preferential treatment for Russian timber imports, to the detriment of U.S. timber exporters.

Antidumping, Countervailing Duty and Safeguard Measures

Since acceding to the WTO, China has emerged as a significant user of antidumping measures, with a total of 67 antidumping measures covering 19 countries currently in place and 42 antidumping investigations in progress. China continued to actively apply its antidumping law in 2005, initiating several new investigations, four of which involved U.S. exports. Chemical products remain the most frequent target of Chinese antidumping actions.

Most of the rules and regulations used by MOFCOM to conduct its antidumping investigations were issued as provisional measures by MOFCOM's predecessor agencies − MOFTEC and the State Economic and Trade Commission − shortly after China acceded to the WTO. While these measures generally represent good-faith efforts to implement the relevant WTO commitments and to improve China's pre-WTO accession measures, they also contain vague language, have gaps in areas of practice and allow inordinate discretion. Meanwhile, China's handling of antidumping investigations and reviews continues to raise concerns in key areas such as transparency and procedural fairness. Concerns with transparency, including access to information, are especially acute with regard to the injury portion of investigations.

To date, China has not initiated a countervailing duty investigation. China's only safeguard measure was removed at the end of 2003 after being in place for less than two years.

The Supreme People's Court has issued a judicial interpretation covering the review of antidumping and other trade remedy decisions. To date, however, judicial review of these types of decisions remains untested.

In one antidumping investigation involving imports of kraft linerboard from the United States, following an affirmative final determination and the imposition of antidumping duties in September 2005, the affected U.S. exporters filed for administrative reconsideration with MOFCOM in which it raised concerns with various aspects of the final determination, particularly the injury finding. Immediately after the United States notified China that it also intended to commence dispute settlement at the WTO, MOFCOM issued a decision repealing the antidumping order.

Non-Tariff Barriers

China's WTO accession agreement obligated China to address many of the non-tariff barriers it had historically used to restrict trade. For example, China is obligated to phase out its import quota system, apply international norms to its testing and standards administration, remove local content requirements, and make its licensing and registration regimes transparent. At the national level, China made progress following its WTO accession in reforming its testing system, revising regulations requiring local content, and improving overall regulatory transparency, including in the licensing area. Despite this progress, however, as China's trade liberalization efforts moved forward, some non-tariff barriers remained in place and others were added.

Four years after China's WTO accession, many U.S. industries complain that they face significant non-tariff barriers to trade, which are discussed in more detail in various sections below. These barriers include, for example, regulations that set high thresholds for entry into service sectors such as banking, insurance and telecommunications, selective and unwarranted inspection requirements for agricultural imports and the use of questionable sanitary and phytosanitary measures to control import volumes. Many U.S. industries have also complained about China's manipulation of technical regulations and standards to favor domestic industries.

Import Quotas

In the past, China often did not announce import quota amounts or the process for allocating import quotas. China set import quotas through negotiations between central and local government officials at the end of each year. Import quotas on most products were eliminated or are scheduled for phase-out under the terms of China's WTO accession. China's accession agreement required China to eliminate existing import quotas for the top U.S. priority products upon accession and phase out remaining import quotas, on industrial goods such as air conditioners, sound and video recording machines, color TVs, cameras, watches, crane lorries and chassis, and motorcycles, by January 1, 2005. While China's post-WTO accession import quota system was beset with problems, China did fully adhere to the agreed schedule for the elimination of all of its import quotas, the last of which China eliminated on January 1, 2005.

Tariff-Rate Quotas

In 1996, China claimed to have introduced a tariff-rate quota (TRQ) system for imports of wheat, corn, rice, soy oil, cotton, barley, and vegetable oils. The quota amounts were not publicly announced, application and allocation procedures were not transparent, and importation occurred through state trading enterprises. China later introduced a TRQ system for fertilizer imports. Under these TRQ systems, China places quantitative restrictions on the amount of these commodities that can enter at a low "in-quota" tariff rate; any imports over that quantity are charged a prohibitively high duty.

As part of its WTO accession commitments, China was to establish large and increasing TRQs for imports of wheat, corn, rice, cotton, wool, sugar, vegetable oils, and fertilizer, with most in-quota duties ranging from 1 percent to 9 percent. Each year, a portion of each TRQ is to be reserved for importation through non-state trading entities. China's accession agreement sets forth specific rules for administration of the TRQs, including increased transparency and reallocation of unused quotas to end-users that have an interest in importing.

For the first two years after China's WTO accession, China's implementation of its TRQ systems generated numerous complaints from foreign suppliers, with the most serious problems being lack of transparency, sub-divisions of the TRQ, small allocation sizes and burdensome licensing procedures. Repeated engagement by U.S. officials led regulatory and operational changes by NDRC for shipments beginning January 1, 2004. Key changes included the elimination of separate allocations for general trade and processing trade, the elimination of certain unnecessary licensing requirements, and the creation of a new mechanism for identifying allocation recipients. In 2004, improvements in NDRC's TRQ administration became evident, although transparency continued to be problematic for some of the commodities subject to TRQs into 2005.

While NDRC was implementing the systemic changes in 2004, exports of some bulk agricultural commodities from the United States showed substantial increases, largely due to market conditions. In particular, despite some continuing problems with NDRC's handling of the cotton TRQs, U.S. cotton exports totaled a record $1.4 billion in 2004. In addition, U.S. wheat exports totaled $495 million in 2004, as the TRQ allocations for wheat did not appear to act as a limiting factor. In 2005, U.S. cotton exports totaled $1.4 billion, while U.S. wheat exports declined significantly to $78 million. The drop in U.S. wheat exports was due to higher production and lower prices in China, which reduced China's overall import demand.

Meanwhile, the administration of China's TRQ system for fertilizer, handled by SETC and subsequently MOFCOM, has suffered from systemic problems since China's WTO accession. By 2005, this system was still operating with insufficient transparency, and administrative guidance still seemed to be affecting how the allocated quota was used. U.S. fertilizer exports to China have declined throughout the post-WTO accession period, due in part to the continuing problems with MOFCOM's administration of the fertilizer TRQ system and in part to increasing subsidization – and resulting overcapacity – of China's domestic fertilizer industry. U.S. fertilizer exports to China have gone from $676 million in 2002 to $459 million in 2003 to $306 million in 2004. In 2005, U.S. fertilizer exports to China remained stable, as the figures for

January through September 2005 showed a slight decrease, totaling $210 million as compared to $215 million during the same period in 2004.

Import Licenses

In the early 1990s, China began to reduce substantially the number of products subject to import licensing requirements. With its WTO accession in December 2001, China committed to the fair and non-discriminatory application of licensing procedures. Among other things, China also committed upon its WTO accession to limit the information that a trader must provide in order to receive a license, to ensure that licenses are not unnecessarily burdensome, and to increase transparency and predictability in the licensing process.

MOFTEC issued new regulations and implementing rules to facilitate licensing procedures shortly after China's accession to the WTO. However, license applicants initially reported that they have had to provide sensitive business details unnecessary for simple import monitoring. In some sectors, importers also reported that MOFTEC was using a "one-license-per-shipment" system rather than providing licenses to firms for multiple shipments. MOFTEC began to allow more than one shipment per license in late 2002 following U.S. interventions, without modifying the measure authorizing the "one-license-per-shipment" system. In December 2004, MOFCOM issued revised licensing procedures for imported goods. Among the changes, import licenses no longer have quantitative restrictions, provisions related to designated trading were removed, and provisions allowing more than one license per shipment and an "under or over provision" for overloaded or short shipments were added.

In May 2005, after Chinese steel producers negotiated contracts with major foreign iron ore suppliers, the Chinese government began imposing new import licensing procedures for iron ore without prior WTO notification. Even though the WTO's Import Licensing Agreement calls for import licensing procedures that do not have a restrictive effect on trade, China reportedly restricts licenses to 48 traders and 70 steel producers and has not made public a list of the qualified enterprises or the qualifying criteria used. While the Chinese government maintained that it did not impose any qualifying criteria, it did acknowledge that two organizations affiliated with the Chinese government, the China Steel Industry Association and the Commercial Chamber for Metals, Minerals and Chemicals Importers and Exporters, had been discussing a set of rules regarding qualifying criteria such as production capacity and trade performance.

China's inspection and quarantine agency, the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ), has also imposed inspection-related requirements that have led to restrictions on imports of some U.S. agricultural goods. In particular, two AQSIQ measures issued in 2002 require importers to obtain a Quarantine Inspection Permit (QIP) prior to signing purchase contracts for nearly all traded agricultural commodities. QIPs are one of the most important trade policy issues affecting the United States and China's other agricultural trading partners.

AQSIQ sometimes slows down or even suspends issuance of QIPs at its discretion, without notifying traders in advance or explaining its reasons, resulting in significant commercial uncertainty. Because of the commercial necessity to contract for commodity shipments when

prices are low, combined with the inherent delays in having QIPs issued, many cargoes of products such as soybeans, meat and poultry arrive in Chinese ports without QIPs, creating delays in discharge and resulting in demurrage bills for Chinese purchasers. In addition, traders report that shipment quantities are often closely scrutinized and are at risk for disapproval if considered too large.

Some improvements were made to the QIP system in 2004 following repeated U.S. engagement, both bilaterally and at the WTO. In June 2004, AQSIQ issued Decree 73, the *Items on Handling the Review and Approval for Entry Animal and Plant Quarantine*, which extended the period of validity for QIPs from three months to six months. AQSIQ also began issuing QIPs more frequently within the established time lines. Nevertheless, a great deal of uncertainty remains even with the extended period of validity, because a QIP still locks purchasers into a very narrow period to purchase, transport and discharge cargoes or containers before the QIP's expiration, and because AQSIQ continues to administer the QIP system in a seemingly arbitrary manner.

Meanwhile, traders are hesitant to press AQSIQ for change because they would risk falling out of favor. Many traders would at least like AQSIQ to eliminate the quantity requirements that it unofficially places on QIPs. These quantity requirements have been used often by AQSIQ during peak harvest periods to limit the flow of commodity imports. Eliminating this requirement would make the QIP system more dependent on market forecast.

In 2005, the QIP system underwent little improvement. AQSIQ officials continued to insist that the QIP system ensures that an adequate number of examiners are on duty at ports when shipments arrive to certify and inspect them for quality and quantity. The United States, with support from other WTO members, has questioned the scientific basis for the QIP system and has maintained that it serves as an unjust and overly restrictive barrier to trade.

INTERNAL POLICIES

Taxation

In April 2001, the National People's Congress Standing Committee passed long-awaited changes to the tax collection law, designed to standardize and increase the transparency of China's tax procedures. The State Council issued detailed regulations for the implementation of this law in September 2002. As part of a broader campaign to "rectify market order" and eliminate inter-provincial barriers to domestic commerce, the Chinese central government also implemented measures to prevent local governments from applying tax treatment that discriminated in favor of locally owned firms.

In order to narrow the widening urban-rural income gap, the Central Committee of the Communist Party of China and the State Council issued Document No. 1 of 2004, which instructed the governments at all levels to reduce the agricultural tax rate of 8.4 percent by 1 percent in 2004, along with the removal of all taxes on special farm produce except for tobacco. Document No. 1 also calls for further reductions in the agricultural tax rate until it is totally eliminated within five years. Where fiscally feasible, governments were also called upon to reduce or eliminate agricultural taxes more quickly. In December 2005, China announced that agricultural taxes would be abolished nationwide effective January 1, 2006.

Foreign investors, including those who have used investment as an entry point to the Chinese domestic market, have benefited from investment incentives, such as tax holidays and grace periods, which allow them to reduce substantially their tax burden. Domestic enterprises have long resented rebates and other tax benefits enjoyed by foreign-invested firms, and these benefits may be gradually phased out. Plans to unify the enterprise income tax laws, which impose higher rates on domestic as compared to foreign enterprises, have been postponed due to policy differences within the central government, and are not expected to take effect before 2007.

Application of China's single most important revenue source – the VAT, which ranges between 13 percent and 17 percent, depending on the product – continues to be uneven. Importers from a wide range of sectors report that, because taxes on imported goods are reliably collected at the border, they are sometimes subject to application of a VAT that their domestic competitors often fail to pay. As discussed above (in the section on Import Substitution Policies), the United States was successful in obtaining China's agreement to remove discriminatory VAT policies favoring domestically produced semiconductors. China's selective exemption of certain fertilizer products from the VAT has also operated to the disadvantage of imports from the United States.

China retains an active VAT rebate program for exports, although rebate payments are often delayed. In 2003, China announced the reduction of VAT rebates for exports by three percentage points partly in response to foreign complaints about an under-valued RMB. Although State Administration of Taxation officials reportedly plan to eliminate rebates eventually in order to increase tax revenues, China has continued this practice in order to spur domestic economic growth. In December 2004, for example, the Ministry of Finance (MOF) and the State Administration of Taxation issued a circular announcing an increase in the VAT rebate rate from 13 percent to 17 percent for the export of certain IT products, including integrated circuits, independent components, mobile telecommunication equipment and terminals, computers and periphery equipment, and numerical-controlled machine tools. In 2005, China adjusted the ratio of the share of the export VAT refund burden between the central and local governments, from 75-25 to 92.5-7.5. China also halted refunds for some products in high demand domestically in order to discourage their export. For example, China eliminated a 13 percent VAT rebate for exports of steel billets and ingots, although it maintained VAT rebates of 11 percent to 13 percent for more processed steel products.

Meanwhile, China continues to consider fundamental reform of its VAT regime from production-based to consumption-based, which began with a pilot program in the Northeast. This reform reportedly may be extended nationwide as early as this year.

China's 1993 consumption tax system continues to raise concerns among U.S. exporters. Because China uses a substantially different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on imported consumer goods ranging from alcoholic beverages to cosmetics to automobiles is higher than for competing domestic products.

Standards, Technical Regulations and Conformity Assessment Procedures

In its WTO accession agreement, China committed that it would ensure that its regulatory authorities apply the same standards, technical regulations and conformity assessment procedures to both imported and domestic goods and use the same fees, processing periods and complaint procedures for both imported and domestic goods. China also committed that, in order to eliminate unnecessary barriers to trade, it would not maintain multiple or duplicative conformity assessment procedures and would not impose requirements exclusively on imported products. China further committed to ensure that its standards developers, regulatory authorities and conformity assessment bodies operated with transparency and allowed reasonable opportunities for public comment on proposed standards, technical regulations and conformity assessment procedures.

In anticipation of these commitments, China devoted significant energy to reforming its standards and testing and certification regimes prior to its WTO entry. In April 2001, China merged its domestic standards and conformity assessment agency and entry-exit inspection and quarantine agency into one new organization, AQSIQ. Chinese officials explained that this merger was designed to eliminate discriminatory treatment of imports, including requirements for multiple testing simply because a product was imported rather than domestically produced. China also formed two quasi-independent agencies administratively under AQSIQ: (1) the Certification and Accreditation Administration of China (CNCA), charged with the task of unifying the country's conformity assessment regime; and (2) the Standardization Administration of China (SAC), responsible for setting mandatory national standards and unifying China's administration of product standards and aligning its standards and technical regulations with international practices and China's commitments under the WTO Agreement on Technical Barriers to Trade (TBT Agreement).

In January 2002, China began the task of bringing its standards regime more in line with international practice with AQSIQ's issuance of rules designed to facilitate China's adoption of international standards. China subsequently embarked on the task of reviewing all of its existing 21,000 technical regulations to determine their continuing relevance and consistency with international standards. In November 2005, China reported that as of October 2005 it had nullified 1,416 national standards as a result of this review.

Nevertheless, in a number of sectors, including autos, auto parts, telecommunications equipment, Internet protocols, wireless local area networks (see the "WAPI" section below), radio frequency identification tag technology, audio and video coding, whiskey and other distilled spirits, and fertilizer, concern has grown as China has pursued the development of unique technical requirements, despite the existence of well-established international standards. These China-specific standards, which sometimes appear to lack a sound basis, could create significant barriers to entry into China's markets because of the high cost of compliance for foreign companies.

The lack of transparency in China's standards development process also troubles many foreign companies. The vast majority of standards-setting bodies are not fully open to foreign participation, in some cases refusing membership to foreign firms and in other cases refusing to

allow companies with majority foreign ownership to vote. In some cases, foreign firms are allowed non-voting observer status, but are required to pay membership fees far in excess of those paid by the voting members. Nevertheless, in 2005, some U.S. companies concluded that China had begun to make steady progress in reforming its standardization system by strengthening its links with standards-setters in other countries and by moving its standards regime into closer conformity with international practice.

China's designated standards notification authority, MOFCOM, has been notifying proposed technical regulations and conformity assessment procedures to WTO members, as required by the TBT Agreement. Almost all of these notified measures have emanated from AQSIQ or SAC, however, and generally have not included measures drafted by other agencies. Lack of meaningful comment periods is also an issue. In many other cases, Chinese regulatory authorities provided insufficient time to consider interested parties' comments before a regulation was adopted.

Despite China's commitment to apply the same standards and fees to domestic and imported products upon its accession to the WTO, many U.S. industries have complained about China's manipulation of technical regulations and standards to favor domestic industries. In fact, SAC issued a strategy report in September 2004 promoting China's development of standards and technical regulations as a means of protecting domestic industry as tariff rates fall. At the sub-national level, importers have expressed concern that local officials do not understand China's WTO commitments and apply arbitrary technical regulations and standards to protect local industries. These problems are compounded by the fact that coordination between AQSIQ and its new affiliated bodies, CNCA and SAC, is lacking, as is coordination between these bodies and China Customs and other ministries and agencies, at both the central and local government levels, with responsibilities relating to technical regulations and standards.

China's new "China Compulsory Certification" (CCC) mark system took full effect on August 1, 2003, following a transition period that lasted for fifteen months. The new CCC mark replaces the old "Great Wall" and "CCIB" marks and is now required for more than 130 product categories, such as electrical machinery, information technology equipment, household appliances and their components.

In 2005, as in prior years, U.S. companies continued to complain that the regulations lack clarity regarding the products that require a CCC mark. They also have reported that China is applying the CCC mark requirements inconsistently and that many domestic products required by AQSIQ's regulations to have the CCC mark are still being sold without the mark. U.S. companies in some sectors further complained that certification remains a difficult, time-consuming and costly process. The process involves on-site inspection of manufacturing facilities outside of China, the cost of which is borne by producers. In addition, small and medium-sized U.S. companies without a presence in China find it particularly burdensome to apply for CCC mark exemptions, such as for replacement and re-export, because China requires the applications to be done in person in the Beijing offices of CNCA. China also continues to require the CCC mark for products that would no longer seem to warrant mandatory certification, such as low-risk products and components.

Meanwhile, to date, China has granted well over one hundred Chinese enterprises accreditation to test and certify for purposes of the CCC mark. Despite China's commitment that qualifying minority foreign-owned (upon China's accession to the WTO) and majority foreign-owned (two years later) joint venture conformity assessment bodies would be eligible for accreditation and would be accorded national treatment, China so far has not granted accreditation to any foreign-invested conformity assessment bodies. As a result, exporters to China are often required to submit their products to Chinese laboratories for tests that have already been performed abroad, resulting in greater expense and a longer time to market.

In other conformity assessment contexts, some importers report discriminatory treatment and uneven enforcement of technical regulations and standards. For example, foreign companies' products can only be tested at certain laboratories. Limited testing and certification capacity means that evaluations sometimes take much longer than international best practice would suggest appropriate. As testing and certification capacity expands to meet this demand, U.S. companies with multi-country operations worry that inexperienced laboratories might make negative determinations that would have global consequences for the company.

Meanwhile, redundant testing requirements continue to trouble U.S. companies, particularly in cosmetics, new chemicals, pharmaceuticals, medical equipment, cellular telephones and other telecommunications products, consumer electronic products and automobiles. For example, China often requires telecommunications and information technology equipment to be tested and certified to the same electro-magnetic compatibility requirements by both MIC and CNCA. In December 2004, SAC created technical committees to develop standards for testing environmental equipment, genetically modified organisms, and new plant and animal varieties, suggesting that foreign companies may soon see additional requirements in these industries as well.

U.S. companies also cite problems with a lack of transparency in the certification process, lack of coordination among standards bodies, burdensome requirements and long processing times for licenses. Some companies have also expressed concern that their intellectual property will be released to competitors when they submit samples of high-technology products for mandatory quality testing. Technical committees that evaluate products for licensing and certification are generally drawn from a pool of government, academic and industrial experts that companies fear may be too closely associated with their competitors. In some cases, laboratories responsible for testing imported products are affiliated with domestic competitors, making the possibility of intellectual property being released more likely.

WAPI

A particularly significant example of China's development of unique technical requirements, despite the existence of well-established international standards, arose in May 2003, when China issued two mandatory standards for encryption over Wireless Local Area Networks (WLANs), applicable to domestic and imported equipment containing WLAN (also known as Wi-Fi) technologies. These standards, which were scheduled to become fully effective in June 2004, incorporated the WLAN Authentication and Privacy Infrastructure (WAPI) encryption technique for secure communications. This component of the standards differed significantly from internationally recognized standards. China sought to enforce the use of WAPI by providing the necessary algorithms only to a limited number of Chinese companies. U.S. and other foreign manufacturers would be compelled to work with and through these companies, some of which were competitors, and provide them with technical product specifications. Following high-level bilateral engagement, AQSIQ, SAC and CNCA jointly announced in April 2004 that China would suspend indefinitely its proposed implementation of WAPI as a mandatory wireless encryption standard, that it would instead work to revise its WAPI standard, taking into account comments received from Chinese and foreign enterprises, and submit it for consideration as an international standard with appropriate international standards setting bodies addressing wireless encryption for computer networks generally. The WAPI standard is currently under consideration by ISO/IEC for adoption as an international standard, and a decision will likely be made in 2006.

On December 30, 2005, MOF, NDRC and MII jointly issued the *Opinions for Implementing Government Procurements of Wireless Local Areas Network*. This measure seems to require all government agencies, quasi-government bodies and government-affiliated organizations, when procuring WLAN and related products using fiscal funds, to give priority to WAPI-compliant products. This measure took effect on February 1, 2006.

Encryption and Decryption Technologies

China generally prohibits foreign-developed encryption and decryption technologies. In the past, this prohibition has not applied to software and hardware for which encryption is only an incidental feature. However, in December 2003, China dramatically changed this precedent with the issuance of standards on encryption for WLAN, which have since been suspended, as discussed in the WAPI section above.

Enhanced Versatile Disc (EVD) Systems

In February 2005, MII announced the issuance of *Technical Standards for Enhanced Versatile Disc Systems*. The recommended, non-compulsory technical standards announced by MII consist of three parts, governing EVD discs, document systems, and data and soundtrack coding for surround-sound speakers. According to MII, these standards will be applicable to the development of chips, software and core parts of EVD players, and will unify the technical standards of the disc and player industries.

The team leader of China's EVD Standards Working Group reportedly stated that the EVD standards will become a technical barrier protecting the domestic industry, reduce the expensive digital versatile disc (DVD) royalty fees domestic firms are currently charged, break the monopoly of foreign DVD firms and provide China with leverage in the international market.

Chemicals

In September 2003, China's State Environmental Protection Administration (SEPA) issued a regulation requiring manufacturers and importers of new chemicals to apply to SEPA's Chemical Registration Center (CRC) for approval and to provide extensive test data to substantiate the physical properties, consumer safety and environmental impact of the new chemical. U.S. industry's primary concerns are that CRC has not been able to make decisions on the approval of new chemicals in a timely manner and that the governing rules and testing requirements are not transparent and accessible. SEPA's CRC acknowledges receipt of more than 40 completed applications for new chemicals since October 15, 2003. According to the most recent information available from CRC, approximately 10 of these applications have been approved. U.S. industry notes that a number of applications have been pending well beyond the 120-day timeline set forth in the regulation. U.S. industry also complains of shifting requirements and implementation changes, such as recently expanded eco-toxicity testing requirements, which mandate that certain eco-toxicity testing, particularly fish eco-toxicity and bio-degradation studies, be carried out in one of six SEPA-accredited laboratories in China. These accredited laboratories have all been established since mid-2004 in response to the September 2003 regulation, and U.S. industry fears that if inexperience leads one of these new labs to declare a product unsafe, it could affect sales globally. China's lack of a low-volume exemption, meaning an exemption where trade in a given chemical falls below an annual volume threshold, also appears to hinder the importation of U.S. chemicals, particularly for high value specialty chemicals sold in small quantities.

Hazardous Substances

In response to the European Union's *Directive on the Restriction of the Use of Hazardous Substances* (EU RoHS Directive), which is scheduled to go into effect on July 1, 2006, China's MII has issued a draft regulation, the *Management Methods for Pollution Prevention and Control in the Production of Electronic Information Products* (China RoHS), which would, like the EU RoHS Directive, ban the use of lead, mercury, cadmium, hexavalent chromium, PBB and PBDE in electronic products. However, at present, this draft regulation is much narrower in scope than the EU RoHS directive, affecting only electronic information products. It is expected that MII will eventually include other types of products and possibly restrict other substances. MII reportedly views a China RoHS regime as an opportunity for China to engage in a new phase of technology innovation with the rest of the world. MII's current goal is to make the China RoHS regime effective early next year.

U.S. industry has been working with MII to improve the draft China RoHS regulation and harmonize it with the EU RoHS regime, with some progress in the area of maximum tolerated thresholds. However, U.S. industry continues to be concerned that harmonization between the EU RoHS and China RoHS regimes will not be achieved, particularly in the areas of marking and labeling, test methods, material declarations and compliance schemes, where the China RoHS regime is overly burdensome and will likely result in significant added expenses and delays without any apparent added benefit to society.

Scrap Recycling

Scrap exports from the United States to China exceed $2 billion annually, making scrap one of the United States' largest exports to China by value. In late 2003, China's AQSIQ issued a notice requiring overseas scrap material exporters to register with AQSIQ. The stated purpose of the new requirement was to better monitor the entry of scrap shipments into China reportedly due to high occurrences of receiving dangerous waste and illegal material in past shipments from overseas. It was not until May 2004 that AQSIQ issued the implementing rules. These rules established registration procedures, including an application deadline of July 1, 2004, and set substantive requirements. In response to U.S. and other WTO members' concerns that the application period was too short, AQSIQ extended the application deadline to August 1, 2004, allowed companies who submitted incomplete applications to supplement required documents and extended the new requirement's effective date from November 1, 2004 to January 1, 2005.

In 2004, AQSIQ made public on its website the names of overseas exporters approved to ship scrap to China in two postings, the first in mid-October and the second at the end of December, only days before the new registration would take effect. In total, about 85 percent of worldwide applicants were granted approval, including hundreds of U.S. exporters. AQSIQ indicated that it would notify applicants that were not approved and that these exporters would be able to apply again six months after receiving notice of their rejection.

On July 29, 2005, AQSIQ posted Bulletin No. 103/2005 on its website, announcing the resumption of the review and approval of registration applications for scrap imports. According to the bulletin, as of August 1, 2005, scrap suppliers must wait three years to reapply for registration if they are denied eligibility. An AQSIQ notice dated December 30, 2005, reports that an additional 260 company registrations had been approved, including 55 U.S. companies.

Meanwhile, U.S. scrap exporters continue to experience problems related to inconsistent and unexplained rejections of licenses, confusing requirements imposed with little or no notice, and rejections of shipments at the point of entry. Problems are also being encountered within the United States as a result of pre-inspection requirements imposed by the Chinese authorities and conducted by Chinese-authorized inspectors at the shipment origin point.

Scrap Waste

In December 2004, China's President Hu Jintao signed Presidential Order No. 31, publishing the amended *Law for the Prevention of Solid Scrap Waste Pollution*, which went into effect in April 2005. According to this law, firms manufacturing, selling and importing items listed in the mandatory reclamation catalogue must recycle these items, and it is illegal to import scrap waste

as component materials that cannot be rendered safe. Depending on the particular item, items that can be safely used as component materials are subject to either restricted import procedures or automatic licensing procedures. The State Administration of Environment Protection (SEPA) is charged with coordinating with MOFCOM, NDRC, China Customs and AQSIQ to design, adjust and publish the catalogues of imported solid scrap waste subject to the restricted or automatic licensing regimes. SEPA and MOFCOM, meanwhile, are responsible for reviewing and issuing licenses for the items subject to restricted import procedures.

Medical Devices

Although China is moving toward greater use of quality systems and utilization of Good Manufacturing Practice audits for medical devices, it still requires outdated type-testing (batch testing) for medical devices. Quality systems audits address product safety and efficacy in a more rigorous manner than type-testing. As a result, requiring firms that have undergone internationally recognized quality systems audits to also be type-tested is redundant and does not provide any additional safety benefits, while it adds unnecessary costs and delays in getting needed medical device products to Chinese patients.

Certain electro-medical devices also face redundant testing by two different agencies, the State Food and Drug Administration (SFDA) and AQSIQ, which administers the "CCC" mark for electrical safety. Both agencies perform virtually identical product tests and factory inspections prior to registration, but they do not recognize the results of one another's tests and inspections. The U.S. medical devices industry reports that this redundancy adds significant time and costs to bringing a new technology to market in China without providing any additional safety benefits.

A similar concern exists for imported pacemakers, which are scanned by AQSIQ upon clearing customs. This review adds unnecessary delay and costs to the distribution of these pacemakers, without providing any additional safety benefits, as pacemakers are re-scanned and re-calibrated by the hospital before implantation into patients.

Sanitary and Phytosanitary (SPS) Measures

In 2005, China's general lack of transparency remained a problem. China either failed to notify or belatedly notified to the WTO numerous SPS measures, resulting in measures that were adopted without the benefit of comments from other interested WTO members. In addition, in some cases, the adopted measures were overly burdensome, appeared to lack a scientific foundation, or raised significant national treatment concerns. U.S. engagement with China at the WTO and bilaterally, including through the provision of technical assistance, has generated some improvements in China's compliance with its WTO transparency obligations. At the same time, however, various U.S. agricultural exports continued to be subjected to unnotified entry, inspection and labeling requirements or faced unwarranted import bans. The most problematic of China's SPS measures are described below.

Bovine Spongiform Encephalopathy (BSE)-Related Bans on Beef and Low-Risk Bovine Products

In December 2003, China and other countries imposed a ban on U.S. cattle, beef and processed beef products in response to a case of BSE found in the United States. Since that time, the

United States has repeatedly provided China with extensive technical information on all aspects of its BSE-related surveillance and mitigation measures, internationally recognized by the OIE as effective and appropriate, for both food safety and animal health. After two years, China still has not provided any scientific justification for continuing to maintain its ban, nor has it identified any of the administrative and regulatory steps necessary to lift the ban. China finally sent a technical team to the United States in October 2005 to gather information on the United States' surveillance and mitigation measures, but no further progress took place during the remainder of the year.

At the same time that it banned U.S. cattle, beef and processed beef products, China also banned low-risk bovine products, i.e., bovine semen and embryos, protein-free tallow and non-ruminant feeds and fats, even though they are deemed tradable based on OIE guidelines regardless of a country's BSE status. After numerous bilateral meetings and technical discussions in 2004, including a visit to U.S. bovine facilities by Chinese food safety officials, China announced a lifting of its BSE-related ban for low-risk bovine products in late September 2004. However, China conditioned the lifting of the ban on the negotiation of protocol agreements setting technical and certification parameters for incoming low-risk bovine products. In November 2004, U.S. and Chinese officials finalized and signed protocols that would enable the resumption of exports of U.S.-origin bovine semen and embryos, contingent on facility certification by China's regulatory authorities, as well as a resumption of exports of U.S.-origin non-ruminant feeds and fats. In July 2005, China finally announced the resumption of trade in bovine semen and embryos, following certifications for 52 U.S. facilities made earlier in the year. However, trade in U.S.-origin non-ruminant feeds and fats did not resume, as China's regulatory authorities were insisting on a series of onerous, detailed and unnecessary information requirements that are not consistent with OIE guidelines and contrast sharply with U.S. requirements. As a result of further negotiations in December 2005, export certificates were finalized, and trade was expected to resume in early 2006. Meanwhile, trade in protein-free tallow had not resumed by the end of 2005, as U.S. and Chinese officials had not reached agreement on provisions of a protocol.

Avian Influenza (AI)

In February 2004, China imposed a nationwide ban on U.S. poultry in response to cases of low-pathogenic AI found in Delaware. Throughout 2004, the U.S. provided technical information to China on the U.S. AI situation, and in August 2004 a high-level Chinese delegation conducted a review of the status of AI eradication efforts in the United States. In December 2004, China lifted its nationwide ban on U.S. poultry, leaving in place a ban only for the states of Connecticut and Rhode Island. In early 2005, following the announcement of low-pathogenic AI found in the state of New York, China did not impose a nationwide ban. Instead, demonstrating progress in following OIE guidelines, China imposed a ban limited to poultry from the state of New York. As part of its ongoing dialogue with China's AQSIQ on AI, the United States has presented epidemiological information in support of its request for China to lift the current import bans on poultry products from Connecticut, Rhode Island and New York.

Wheat

The 1999 U.S.-China Agricultural Cooperation Agreement established an agreed level of TCK fungus tolerance in U.S. wheat, and China no longer routinely blocks U.S. wheat exports from the Pacific Northwest on the basis of the TCK fungus. Nevertheless, China has imposed a maximum residue level (MRL) for selenium that is more stringent than the international standard and threatens U.S. wheat exports to China. In addition, China has imposed an MRL for vomitoxin in wheat in the absence of any international standard. Although these measures are problematic, U.S. exports of wheat to China appeared to be unaffected by them in 2005. The drop in U.S. wheat exports in 2005 was attributable to other factors (as discussed in the "Tariff-Rate Quotas" section above).

Zero Pathogen Standards

China enforces zero tolerance standards for certain pathogens in raw meat and poultry products – standards that have resulted in the de-listing of several U.S. meat and poultry facilities. These standards appear to be enforced inconsistently. For some of the pathogens, a zero tolerance is not achievable because certain pathogen levels are unavoidable and do not result in unacceptable risk to consumers. These standards were developed by the Ministry of Health (MOH) and are enforced by AQSIQ. It does not appear that the Chinese authorities apply these standards equally to domestic products. Non-transparent enforcement of these standards has caused minor export disruptions since 2003.

The United States has worked with the Chinese authorities to re-list the affected facilities. It also continues to press China to revise its pathogen standards based on sound science and to adopt modern testing methodologies. Based on actions taken by the Chinese authorities in December 2005, it is expected that zero pathogen standards will become a more significant issue in 2006.

Distilled Spirits

China maintains a mandatory standard on distilled spirits that sets maximum limits on naturally occurring substances, know as superior alcohols or fusel oils, which result from the production process. However, the Joint UN FAO/WHO Expert Committee on Food Additives, like U.S. regulators of alcohol, has recognized that superior alcohols are safe for human consumption.

Food Additive Standards

Another problematic area involves China's overly restrictive food additive standards. China continues to block many U.S. processed food products from entering the Chinese market by banning certain food additives that are widely used in other countries and have been approved by the World Health Organization. The most recent example is China's proposed *Hygienic Standard for Uses of Food Additives*, notified to the WTO in July 2005 so that WTO members could comment on it.

This proposed technical regulation is 237 pages long and covers dozens of residues and additives for nearly 1,000 commodities. In some cases, it employs domestic nomenclature rather than internationally recognized technical terms, making it difficult to assess the impact that it would have on specific products. The United States recently submitted detailed comments on the proposed technical regulation and asked China to delay adoption of it until a thorough review could take place.

Fire Blight

Since 1994, China has refused to act on the United States' market access request for California plums, allegedly due to phytosanitary concerns regarding fire blight. In June 2005, the WTO Appellate Body report in *Japan - Measures Affecting the Importation of Apples* made clear that these concerns are unwarranted for imports of mature symptomless fruit. In December 2005, following further U.S. interventions, China formally approved the market access request for California plums.

Biotechnology Regulations

In January 2002, the Ministry of Agriculture (MOA) issued new rules implementing June 2001 regulations on agricultural biotechnology safety, testing and labeling. The product most affected by these rules was soybeans, while corn and other commodities were also potentially affected. However, the rules did not provide adequate time for completion of required safety assessments before their effective date of March 20, 2002. In response to U.S. interventions, China issued interim rules, which allowed trade to continue while authorities carried out safety assessments of biotechnology products. These interim rules were extended twice and were set to expire in April 2004. In December 2003 talks, MOA officials promised that permanent approval of Round-up Ready soybeans would be completed at least 60 days before expiration of the interim rules in order to prevent any trade disruption. China followed through on this promise and approved Round-up Ready soybeans, along with two cotton events and two corn events, in February 2004. Two months later, China issued final safety certificates for four additional corn events and seven canola events. China issued a formal safety certificate for another corn event later in 2004, leaving only one corn event still awaiting final approval. During the July 2005 JCCT meeting, MOA issued the final safety certificate for the remaining corn event.

Other U.S. concerns with China's biotechnology regulations remain. Areas of concern include limited timelines for submission of products, lack of clarity on assessment requirements for stacked (multiple trait) products and, at times, duplicative and unprecedented testing requirements. The United States is also concerned with the apparent lack of coordination of the development of biotechnology policy in China.

Food Labeling

The U.S. processed food industry has registered concerns with a number of standards and labeling requirements on its exports to China. The meat industry in particular is concerned that labeling regulations issued in late 2002 contain several requirements that go beyond those of any other country. They assert that these requirements are unnecessary and costly.

Agricultural importers and importers of processed foods are also concerned about measures requiring labels for products containing transgenic material, such as soybeans and corn. The June 2001 biotechnology regulations issued by MOA require labeling of bulk commodities, but implementation has been limited and sporadic. Future implementation of these measures remains uncertain.

The distilled spirits industry is concerned that China will require its products to comply with all existing food labeling requirements. The industry believes that some of these requirements are inappropriate. For example, China requires distilled spirits product labels to include a bottling date. Under international practice relating to wines and spirits, however, the date of manufacture (production or bottling date) is not required. As many spirits products consist of a blend of spirits that are aged for varying periods, a single "date of manufacture" is often not possible to specify, would not represent the actual age of the product, and would confuse consumers regarding the actual age of the product. China also requires the labels of distilled spirits products to include a list of ingredients, even though the original ingredients (e.g., corn, wheat, rye and barley) are completely transformed and are no longer present after distillation. Furthermore, China maintains typeface specifications and translation requirements that are inconsistent with international standards.

EXPORT REGULATION

Export Licenses and Quotas

Over the last several years, China has progressively reduced the number of products requiring some type of export license. In 2005, China continued this trend, as it freed up three more categories of products from this requirement (man-made jade, satin and some kinds of silk). However, 47 categories of products (totaling 316 items at the 8-digit tariff level) are still subject to various types of export licenses. Products requiring export licenses include some grains, cotton, livestock, raw materials and metals, lethal chemicals and food products. In addition, China occasionally imposes new export licensing requirements on strategically sensitive commodities.

For some products, such as blast furnace coke and fluorspar, the export licensing system raises strong concerns under WTO rules that generally prohibit export restrictions. Export licenses for these two products are accompanied by export quotas and at times have required the payment of high export license fees beyond the administrative costs of administering an export license system.

In 2004, China's export restrictions on blast furnace coke, a key steel input, began to have a significant, adverse effect on U.S. integrated steel producers and their customers. The United States began to raise its concerns with China's coke export restrictions during high-level meetings in Washington in April 2004. The United States urged China to eliminate the practice of using export restrictions, not just for coke but also for other products. In late July 2004, China raised the 2004 quota allotment for coke to 12.3 million MT, and it indicated that it would eventually raise the quota to the 2003 level of 14.3 million MT.

Shortly thereafter, MOFCOM also issued an urgent notice reiterating that the sale of export licenses was illegal. In the ensuing months, with the increased supply of Chinese coke and the crackdown on the sale of export licenses, the export prices for Chinese coke declined significantly. U.S. industry was also able to obtain a substantially larger quantity of Chinese coke in 2004 than it had in 2003.

In May 2005, consistent with earlier indications from China, an NDRC official stated publicly that China would eliminate the coke export quota system as of January 1, 2006. A MOFCOM official also noted that while WTO rules allow member countries to impose quotas on exports under certain circumstances, the rules simultaneously require restrictions on domestic consumption, which had not been done to date. In November 2005, when MOFCOM announced the 2006 export quota levels for agricultural, industrial and textile products, coke was absent from the list. MOFCOM later indicated that coke would still be subject to an export quota, except the export quota would now be administered by the NDRC, not MOFCOM. The reason given for the switch in coke export quota administration is that NDRC is responsible for administrating industrial products that have significant influence on the national economy. In early December 2005, the NDRC released a list of 2006 coal export quotas, but did not include coke. In late December 2005, the NDRC finally issued the coke export quota, set at 14 million MT for 2006.

China has imposed quotas and high license fees on exports of fluorspar since before it acceded to the WTO, apparently with the objective of supporting China's domestic users of fluorspar, which face no comparable restrictions. China has refused to modify its practices in this area, despite repeated U.S. requests.

In December 2004, in an apparent effort by China to manage the export growth of textile and apparel products in response to concerns from its trading partners as the January 1, 2005 deadline for removal of global textile quotas drew near, China announced plans to impose export duties on certain categories of textile and apparel products. In February 2005, MOFCOM issued rules imposing automatic licensing requirements for textile exports to the United States, the European Union and Hong Kong. Subsequently, China suspended the licensing requirements only to restore similar measures in June 2005 and July 2005 after the United States imposed safeguards on certain categories of textile imports from China. China claimed the measures were needed to avoid uncertainty among Chinese textile exporting firms, to encourage exports of high value added items and to avoid rent seeking in license distributions. Under the June 2005 measures, MOFCOM, China Customs and AQSIQ jointly issued and made adjustments to a catalogue of subject items, listed by tariff codes, destination countries and regions, implementing periods and total licensed export quantities of subject items. Included in the catalogue were textile products subject to foreign safeguard actions or those subject to temporary quantitative regulation in accordance with bilateral agreements. In November 2005, USTR and MOFCOM signed a memorandum of understanding (MOU), under which China agreed to limit export growth rates in 34 categories of textiles, representing approximately 40 percent of bilateral trade in textiles, through 2008. The United States in turn agreed to dismiss all pending China-specific textile safeguard investigations and agreed to exercise restraint in invoking safeguards for categories of textiles falling outside the MOU. The United States and China also established an Electronic Visa Information System (ELVIS) Arrangement to monitor trade in the affected products.

China also requires export licenses on products that are the subject of antidumping duties in a foreign market. As was initially the case in 2005 for textile exports subject to safeguard limitations in the United States, the central government has often delegated responsibility for issuing these licenses to quasi-governmental industry associations formed to take the place of the ministries that governed production during the earlier central planning era. Foreign investors report that the industry associations are using the power to issue export licenses to force companies to participate in association-supported activities. For example, the steel producers' industry association will not issue an export license to any company that does not contribute to its antidumping defense funds.

Export Subsidies

China officially abolished subsidies in the form of direct budgetary outlays for exports of industrial goods on January 1, 1991. China agreed to eliminate all subsidies prohibited under Article 3 of the WTO Agreement on Subsidies and Countervailing Measures, including all forms of export subsidies on industrial and agricultural goods, upon its accession to the WTO in December 2001.

A general lack of transparency makes it difficult to identify and quantify possible export subsidies provided by the Chinese government. China's subsidy programs are often the result of internal administrative measures and are not publicized. Sometimes they take the form of income tax reductions or exemptions that are *de facto* contingent on export performance. For example, the Chinese government announced in 2005 that it would provide financial and export credit assistance for automobile manufacturers with domestically owned intellectual property rights and noted that MOFCOM is selecting 100 Chinese auto or auto parts manufacturers to be designated as "state-level auto and part exporters" for financial support. In addition, according to a 2002 OECD report, foreign-invested enterprises exporting 70 percent or more of their output in a given year are eligible for a 50 percent tax reduction in that year even after the expiry of the normal tax holiday. China's subsidy programs can also take a variety of other forms, including mechanisms such as credit allocations, low-interest loans, debt forgiveness and reduction of freight charges. U.S. industry has alleged that subsidization is a key reason that Chinese exports are undercutting prices in the United States and gaining market share. Of particular concern are China's practices in the textiles industry as well as in the steel, petrochemical, high technology, forestry and paper products, machinery and copper and other non-ferrous metals industries.

U.S. subsidy experts continue to seek more information about several Chinese programs and policies that may confer export subsidies. Their efforts have been frustrated in part because China has failed to make any of its required subsidies notifications since becoming a member of the WTO three years ago. At the July 2005 JCCT meeting and in formal meetings at the WTO, China committed to submit its long-overdue subsidies notification by the end of 2005. China did not meet this deadline.

Since shortly after China acceded to the WTO, U.S. corn exporters began to complain that China was subsidizing its corn exports. In 2002 and 2003, it appeared that significant quantities of corn had been exported from China, including corn from Chinese government stocks, at prices that may have been 15 percent to 20 percent below domestic prices in China. As a result, U.S. corn

exporters were losing market share for corn in their traditional Asian markets, such as South Korea and Malaysia, while China was exporting record amounts of corn. In 2004, however, trade analysts began to conclude that, because of several economic factors, including changes in the relationship between domestic prices and world prices, China was trending toward becoming a net importer of corn. One result appeared to have been that China's exports were largely made on a commercial basis in 2004 and 2005, although concern remains regarding the operation of China's VAT rebate system for corn.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

China has undertaken substantial efforts to implement its commitment to overhaul its legal regime to ensure the protection of intellectual property rights in accordance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). Those efforts have fallen short in some respects, particularly with regard to criminal liability for copyright piracy and trademark counterfeiting. In other areas, China has done a relatively good job of revising its legal regime. However, China has been much less successful in enforcing its laws and regulations and ensuring the effective IPR enforcement required by the TRIPS Agreement. With U.S. industry reporting no significant reduction in IPR infringement levels in 2005, IPR enforcement remains problematic. Counterfeiting and piracy in China remain at epidemic levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy.

Throughout 2005, the United States continued to place the highest priority on improving IPR enforcement in China, taking several aggressive steps in an effort to obtain meaningful progress in this area. First, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch List" and set out a comprehensive strategy for addressing China's ineffective IPR enforcement regime, including the possible use of WTO mechanisms, as appropriate. The United States immediately began to pursue this strategy during the run up to the July 2005 JCCT meeting, and China subsequently agreed to take a series of specific actions designed to increase criminal prosecutions of IPR violators, improve enforcement at the Chinese border, counter piracy of movies, audio visual products and software, address Internet-related piracy, and appoint an IPR ombudsman to serve as a point of contact for U.S. companies, particularly small and medium sized U.S. companies experiencing China-related IPR problems. After concluding that lack of transparency is a serious barrier to a more complete understanding of key deficiencies in China's IPR enforcement system, the United States also submitted a transparency request to China under Article 63.3 of the TRIPS Agreement in October 2005. The request, made in conjunction with similar requests by Japan and Switzerland, seeks detailed information from China on its IPR enforcement efforts over the last four years.

The United States is committed to working constructively with China to significantly reduce IPR infringement levels in China and continues to devote extra staff and resources, both in Washington and in Beijing, to address the many aspects of this problem.

At the same time, the United States remains prepared to take whatever action is necessary and appropriate to ensure that China develops and implements an effective system of IPR enforcement, as required by the TRIPS Agreement.

Legal Framework

In anticipation of its accession to the WTO, China began modifying the full range of IPR laws, regulations and implementing rules, including those relating to patents, trademarks and copyrights, in an effort to comply with the TRIPS Agreement. By the end of 2001, China had completed amendments to its patent law, trademark law and copyright law, along with regulations for the patent law and regulations addressing computer software protection and the protection of layout designs of integrated circuits. After it acceded to the WTO, China issued regulations for the trademark law and the copyright law. China also issued various sets of implementing rules and judicial interpretations in the patent, trademark and copyright areas. In addition, China issued regulations and implementing rules covering specific subject areas, such as integrated circuits, computer software and pharmaceuticals. Many of the legal changes made by China represent major improvements that have moved China generally in line with international norms in most key areas. More work needs to be done, however, particularly with regard to administrative and criminal enforcement. In addition, new legislation may be required in certain "cutting edge" areas like Internet copyright protection.

In the trademark area, some progress was made in 2004 on the recognition of foreign well-known marks. More than a year after the issuance of implementing rules on well-known marks, a handful of foreign marks has been recognized as well-known. In addition, in June 2005, the Trademark Administration circulated draft amendments to its *Regulations on the Timely Transfer of Suspected Criminal Cases in the Enforcement of Administrative Law*, which are designed to provide guidance to provincial administrations for industry and commerce in facilitating effective trademark enforcement and protection.

With regard to copyright protection over information networks, in November 2004, the National Copyright Administration of China and MII jointly organized a hearing on draft implementing rules known as the *Draft Measures for Administrative Protection of Copyright on the Internet*. The Chinese authorities issued these rules in final form in April 2005. The rules require Internet service providers to take remedial actions to delete contents that infringe on copyrights upon receipt of a complaint from the right holder, or face administrative penalties ranging from confiscation of illegal gains to fines of up to RMB 100,000 ($12,000). In September 2005, China circulated a more important Internet-related measure for public comment, the draft *Regulations on the Protection of Copyright Over Information Networks*, with the goal of issuing the final version in 2006. This development is a concrete step in line with China's April 2004 JCCT commitments to improve protection of electronic data while China continues its preparations for accession to the WIPO Internet-related treaties − the *WIPO Copyright Treaty* and the *WIPO Performances and Phonograms Treaty*.

Although China is not obligated under WTO rules to accede to the WIPO Internet-related treaties, the United States considers these treaties to reflect international norms for providing copyright protection over the Internet. These treaties entered into force in 2002 and have been

ratified by many developed and developing countries. While China's existing regulations and implementing rules do address certain copyright issues related to the Internet, and China is in the process of drafting further revisions, the United States has urged China for some time to accede to the WIPO Internet-related treaties and fully harmonize its regulations and implementing rules with them. These steps are important as a means for preventing China's Internet environment from becoming a "safe harbor" for piracy, especially in light of the rapidly increasing number of Internet users in China, most of whom have broadband access. At the April 2004 JCCT meeting, China agreed to ratify and implement the WIPO Internet-related treaties as soon as possible.

At the July 2005 JCCT meeting, the United States obtained China's commitment to submit the legislative package necessary for China's accession to the WIPO Internet-related treaties to the National People's Congress by June 2006.

In furtherance of China's April 2004 JCCT commitment to increase border measures protecting against the import and export of infringing products and to make it easier for rights-holders to secure effective enforcement at the border, the Customs Administration issued the *Regulations on Customs Protection of Intellectual Property Rights*, which went into effect in March 2004. The Customs Administration subsequently issued implementing rules for these regulations, effective July 2004. These regulations and implementing rules addressed the duties of the Customs Administration and improved guidance on the implementation of the customs IPR recordal mechanism. In other areas, however, the regulations and implementing rules lacked clarity or could have benefitted from further changes, such as with regard to the storage and disposition of infringing goods and the transferal of cases for possible criminal prosecution. Meanwhile, in September 2004, the Customs Administration issued new regulations on administrative penalties in the customs context, the *Implementing Regulations for the Imposition of Administrative Penalties by the General Administration of Customs*, effective November 2004. In an apparent improvement over the prior regulations, these new regulations do not impose a "knowledge" requirement before penalties can be imposed. However, the new regulations provide for fines not to exceed 30 percent of the value of the goods confiscated, or RMB 50,000 ($6,000), whichever is lower. In contrast, the prior regulations allowed for fines up to the full value of the goods confiscated. The fines allowed under the new regulations are also lower than those imposed by other Chinese agencies focusing on domestic IPR infringement. At present, the effectiveness of these various regulations and implementing rules remains in doubt, as exports of counterfeit and pirated goods from China are increasing, facilitated by trading rights liberalization and the rapid growth of Internet usage and e-commerce.

The United States has urged China to pursue additional legislative changes to improve the legal framework supporting enforcement, particularly in the area of criminal enforcement. For example, the criminal enforcement legal framework could be improved through the removal of various evidentiary and liability thresholds, the "for profit" requirement in the copyright area, the "identical trademark" requirement and the distinction between individual and enterprise liability. Among these issues, China's high thresholds for criminal liability (i.e., the minimum values or volumes of infringement deemed criminal by authorities) pose a particular problem.

Despite efforts at reform, these thresholds remain so high that they have the effect of insulating commercial infringers' retail sales and other significant commercial activities involving counterfeit and pirated goods from criminal penalties. China's legal framework has thus created a "safe harbor" that protects a large group of commercial infringers and operates to deprive the criminal enforcement authorities of needed information regarding the sources of counterfeit and pirated goods.

The United States also remains concerned about weaknesses in China's legal framework that encourage or support counterfeiting and piracy. Some of these weaknesses have facilitated the establishment of Chinese companies under the false appearances of foreign companies, the squatting of foreign company names, designs and trademarks, and the theft of trade secrets.

In addition, restrictions on market access for legitimate movies, music, software and books and built-in delays in the marketing approval system for pharmaceuticals have created incentives for counterfeiting and piracy that are difficult to address through the existing legal framework.

Enforcement

IPR infringement in China in 2005 continued to affect products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, consumer goods, industrial goods, food products, medical devices, electrical equipment, automotive parts and clothing, among many others. This situation not only has had an enormous economic impact, but also presents a direct challenge to China's ability to regulate many products that have health and safety implications for China's population and, given the increasing amount of counterfeit and pirated products being exported from China, for others around the world.

The United States places the highest priority on addressing IPR enforcement problems in China, and since 2004 it has devoted additional staff and resources, both in Washington and in Beijing, to address these problems. While a domestic Chinese business constituency is increasingly active in promoting IPR enforcement, it is clear that there will continue to be a need for sustained efforts from the United States and other WTO members, along with the devotion of considerable resources and political will by the Chinese government to IPR enforcement, if significant improvements are to be achieved on this front. At present, however, China's IPR enforcement efforts remain hampered by the challenges of coordination among Chinese government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting cases, and inadequate and non-transparent administrative penalties.

At the April 2004 JCCT meeting, China announced a comprehensive action plan on IPR enforcement that included five major commitments, for which the results have been mixed. First, and most importantly, China agreed that it would significantly reduce IPR infringement levels. Nevertheless, IPR infringement in China remains rampant, and IPR infringement levels reported by U.S. industry have not improved. Second, China committed that it would take steps by the end of 2004 to increase penalties for IPR violations by subjecting a greater range of violations to criminal investigation, applying criminal sanctions to the import, export, storage

and distribution of pirated and counterfeit products and applying criminal sanctions to on-line piracy. China did take some steps to increase penalties for IPR violations, as China's Supreme People's Court and Supreme People's Procuratorate issued a judicial interpretation in December 2004 redefining the criteria for commencing criminal prosecutions and reaching criminal convictions. Nevertheless, while this judicial interpretation has generated improvements, it did not address deficiencies in China's criminal law still in need of correction. Third, China committed to crack down on IPR violators by conducting nation-wide enforcement actions and increasing customs enforcement actions. Vice Premier Wu launched this crack down at the time of the Xiamen China International Fair for Investment and Trade in August 2004. However, a lack of transparency hinders an assessment of the disposition of any ensuing enforcement and customs actions. Fourth, China committed to improve protection of on-line works by ratifying and implementing the World Intellectual Property Organization (WIPO) Internet-related treaties as soon as possible, and by extending an existing ban on the use of pirated software in government offices. Although China has not yet ratified the WIPO Internet-related treaties, the Chinese government did extend its ban on the use of pirated software in government offices. Fifth, China committed to launch a national IPR education campaign. China followed through on this commitment by launching a national public awareness campaign to educate the Chinese public on IPR protection, which included radio and television programs, newspaper inserts, awards and national and local level training programs. The campaign also included the introduction of a television program, "Intellectual Fortune," which is broadcasted in 20 provinces nationwide, the publication of an English language inserts in the China Daily English-language newspaper on intellectual property, and radio broadcast programs, among other targeted efforts. The long-term impact of these efforts continues to be evaluated.

In early 2005, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch List" and set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, which included the possible use of WTO mechanisms, as appropriate.

The United States immediately began to pursue this strategy during the run-up to the July 2005 JCCT meeting, as the United States sought to strengthen the commitments that China had made at the April 2004 JCCT meeting and to obtain China's commitment for greater involvement of its police authorities in IPR enforcement matters. China subsequently agreed to: (1) increase criminal prosecutions for IPR violations relative to the total number of IPR administrative enforcement cases; (2) reduce exports of infringing goods by issuing regulations to ensure the timely transfer of cases for criminal investigation; (3) improve national police coordination by establishing a coordinating group in the Ministry of Public Security responsible for overall research, planning and coordination of all IPR criminal enforcement to ensure a focused and coordinated nationwide enforcement effort; (4) enhance cooperation on law enforcement matters with the United States by immediately establishing a bilateral IPR law enforcement working group focusing on the reduction of cross-border infringement activities; (5) expand an ongoing initiative to aggressively counter piracy of movies and audio-visual products; (6) complete its program ensuring that only licensed software is used by all central, provincial and local government offices by the end of 2005 and extend this program to enterprises in 2006; (7) fight software end-user piracy by declaring that it is considered to constitute "harm to the public

interest" and therefore is subject to administrative penalties nationwide and criminal penalties in appropriate circumstances; (8) establish an IPR ombudsman in the Chinese embassy in Washington to assist U.S. companies, particularly small- and medium-sized companies, experiencing IPR problems, (9) develop measures to rid trade fairs of fake goods; (10) join the WIPO Internet-related treaties in 2006; and (11) clarify the December 2004 Judicial Interpretation to make clear that its criminal thresholds apply to sound recordings and that exporters are subject to independent criminal liability.

By the end of 2005, China had already taken several steps to implement these commitments. Nevertheless, the overall results of China's efforts remain unclear, largely because of transparency problems associated with IPR enforcement activities in China. For example, China will not make public the enforcement decisions made by administrative authorities. China has issued statistics that appear to show some increase in enforcement activities, but there is no evidence of any significant corresponding reduction in IPR infringement levels. In October 2005, the United States submitted a request to China under the transparency provisions of Article 63 of the TRIPS Agreement, in conjunction with similar requests by Japan and Switzerland, seeking to clarify China's efforts to improve IPR enforcement.

A detailed review of the three different mechanisms for IPR enforcement provided for by China's IPR laws and regulations – enforcement by administrative authorities, criminal prosecutions and civil actions for monetary damages or injunctive relief – is set forth below.

Administrative Enforcement

Although the central government continues to promote periodic anti-counterfeiting and anti-piracy campaigns, and these campaigns in the short term result in high numbers of seizures of infringing materials, they are largely ineffective. For one thing, the cases subsequently brought by the administrative authorities usually result in artificially low fines because the administrative authorities often do not treat the infringing goods as having the value of the genuine articles, but rather establish value based on the price charged for the counterfeit or pirated goods. In addition, evidence showing that a person was caught warehousing infringing goods is not sufficient to prove an intent to sell them, and as a result the administrative authorities will not even include those goods in the value of the infringing goods when determining the fine amounts.

The lack of deterrence from the fines is compounded by the fact that the administrative authorities rarely forward an administrative case on to the Ministry of Public Security for criminal investigation, even for commercial-scale counterfeiting or piracy. Statistics provided by China confirm this fact. In 2004, only 96 out of 51,851 administrative trademark cases (approximately 0.2 percent) and 101 out of 9,691 administrative copyright cases (approximately 1.0 percent) were transferred for criminal prosecution. These statistics showed no improvement over 2001, when the corresponding statistics similarly indicated very low transfer rates of 0.2 percent for administrative trademark cases and 1.5 percent for administrative copyright cases. As a result, infringers continue to consider the seizures and fines simply to be a cost of doing business, and are usually able to resume their operations without much difficulty.

At the 2005 JCCT meeting, as discussed above, China committed to increase the number of criminal IPR prosecutions relative to the number of administrative IPR cases. Since then, China has prepared and made available for public comment draft rules to facilitate the transfer of administrative cases for criminal enforcement. The United States has submitted written comments on these draft rules, which were expected to be finalized by the end of 2005. China is working separately on draft rules for the transfer of customs cases for criminal enforcement.

Meanwhile, China's administrative enforcement efforts have also failed to put an end to open and notorious IPR infringement at trade fairs, retail markets and wholesale markets throughout China. The United States has urged China to step up efforts at retail markets such as the "Silk Street" market in Beijing and wholesale markets such as Xiangyang in Shanghai, Yiwu in Yiwu City, and Lowu in Shenzhen. At major trade fairs, exhibitors displaying infringing goods in the past have escaped with only non-deterrent administrative penalties. China pledged to address the trade fair problem as part of its July 2005 JCCT commitments, and it is expected to issue final measures designed to improve administrative IPR enforcement at trade fairs, including provisions enhancing on-site complaint centers at major fairs, in early 2006.

The Customs Administration developed an action plan in mid-2004 calling for increased enforcement over exports of infringing goods, in conformity with China's April 2004 JCCT commitments. Currently, China's share of U.S. seizures of exports of counterfeit and pirated goods remain very high, although mid-year 2005 U.S. Customs and Border Patrol seizure data did show a modest decrease in seizures of infringing imports from China as compared with the same period in 2004, both in terms of aggregate value and percentage of total seizures.

Criminal Enforcement

In the view of the United States and U.S. industry, the most critical steps for China to take in improving its IPR enforcement are in the criminal area. Effective criminal enforcement is a core WTO obligation, and it offers the deterrence needed for China to begin to handle the rampant IPR infringement hurting both foreign and domestic enterprises. For this reason, the United States sought and obtained at the April 2004 and July 2005 JCCT meetings commitments by China to apply criminal sanctions to a wider range of IPR-infringing activities, to increase the penalties for IPR violations, to increase the number of criminal prosecutions for IPR violations, to reduce exports of infringing goods through the timely transfer of cases for criminal investigation, to improve national police coordination, and to ensure that its criminal thresholds apply to sound recordings and that exporters are subject to independent criminal liability.

There are some reports that the number of criminal prosecutions in China has increased in certain types of cases, but lack of transparency makes it difficult to confirm the existence, extent or significance of any improvement. Criminal prosecutions remain very rare in relation to administrative cases, and they have not created an adequate deterrent for IPR infringers. U.S. companies also continue to complain that, in most regions of China, the police are either not interested in pursuing counterfeiting and piracy cases or simply lack the resources and training required to investigate these types of cases effectively. Moreover, even when IPR violations are referred for criminal enforcement, the actual prosecution of IPR crimes frequently requires coordination among a relatively large number of agencies at the national and local levels.

Coordination remains problematic, however, with different agencies using different standards to determine whether criminal conduct exists and some agencies apparently unwilling or unable to work together.

Civil Enforcement

In part because of the ineffectiveness of the administrative and criminal enforcement mechanisms in China, particularly in the copyright area, there has been an increase in the number of civil actions being brought for monetary damages or injunctive relief. Most of the civil actions have been brought by Chinese rights-holders. This increased use of civil actions has coincided with an increasing sophistication on behalf of China's IPR courts, as China continues to make efforts to upgrade its judicial system. These efforts are still in progress, however. U.S. companies still complain about local protectionism and have also found that most judges lack necessary technical training and that court rules regarding evidence, expert witnesses, and protection of confidential information are vague or ineffective. In addition, in the patent area, where enforcement through civil litigation is of particular importance, a single case still takes several years to complete, rendering the damages provisions adopted to comply with China's TRIPS Agreement obligations less meaningful.

SERVICES BARRIERS

Until China's entry into the WTO, China's service sectors were among the most heavily regulated and protected sectors of the national economy. Foreign service providers were largely restricted to operations under the terms of selective "experimental" licenses. However, both as a matter of policy and as a result of its WTO commitments, China decided to significantly liberalize foreign investment in its service sectors. At present, the market for services, underdeveloped due to historical attitudes and policies, has significant growth potential in both the short and long term.

China's WTO commitments are designed to provide meaningful access for U.S. service providers. In its accession agreement, China committed to the substantial opening of a broad range of service sectors through the elimination of many existing limitations on market access, at all levels of government, particularly in sectors of importance to the United States, such as banking, insurance, distribution, telecommunications and professional services. These commitments are far-reaching, particularly when compared to the services commitments of many other WTO members.

China also made certain "horizontal" commitments, which apply to all sectors listed in its services schedule. The two most important of these cross-cutting commitments involve acquired rights and the licensing process. Under the acquired rights commitment, China agreed that the conditions of ownership, operation and scope of activities for a foreign company, as set out in the respective contractual or shareholder agreement or in a license establishing or authorizing the operation or supply of services by an existing foreign service supplier, will not be made more restrictive than they were on the date of China's accession to the WTO.

In other words, if a foreign company had pre-WTO accession rights that went beyond the commitments made by China in its services schedule that company could continue to operate with those rights. In the licensing area, prior to China's WTO accession, foreign companies in many sectors did not have an unqualified right to apply for a license to operate in China. They could only apply for a license if they first received an invitation from the relevant Chinese regulatory authorities, and even then the decision-making process lacked transparency and was subject to inordinate delay and discretion. In its accession agreement, China committed to licensing procedures that were streamlined, transparent and more predictable.

At present, many challenges remain in securing the benefits of China's services commitments. While China continued to keep pace nominally with the openings required by its WTO accession agreement, it frequently maintained or erected terms of entry that were so high or cumbersome as to prevent or discourage many foreign suppliers from gaining market access. For example, despite some progress, excessive capital requirements continue to restrict market entry for foreign suppliers in many sectors, such as insurance, banking, securities, non-bank motor vehicle financing, asset management, direct selling, franchising, freight forwarding and telecommunications, among others. In addition, in sectors such as insurance and legal services, branching restrictions have been put into effect that call into question commitments made by China in its services schedule. In other sectors, particularly express delivery and construction services, problematic proposed or final measures continue to threaten to take away previously acquired market access rights.

Progress was made on some fronts in 2005. For example, the licensing process in many sectors continued to proceed in a workman-like fashion, although national treatment concerns remain, particularly in the banking and insurance sectors. The *Administrative Licensing Law*, which took effect in July 2004, has also increased transparency in the licensing process, while reducing procedural obstacles and strengthening the legal environment for domestic and foreign enterprises.

Insurance Services

In its WTO accession agreement, China agreed to phase-in expanded ownership rights for foreign companies, for the most part during the first three years of China's WTO membership. Upon China's accession to the WTO, foreign life insurers were to be permitted to hold 50 percent equity share in a joint venture; within two years of accession, foreign property, casualty and other non-life insurers were to be permitted to establish as a branch, joint venture or a wholly foreign-owned subsidiary; and, within three years of accession, or by December 11, 2004, foreign insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance were to be permitted 51 percent foreign equity share in a joint venture (with the right to establish as a wholly foreign-owned subsidiary within two more years). China further agreed that all foreign insurers would be permitted to expand the scope of their activities to include group, health and pension lines of insurance by December 11, 2004. In addition, China agreed to eliminate geographic restrictions on all types of insurance operations by December 11, 2004.

Shortly after China acceded to the WTO, the China Insurance Regulatory Commission (CIRC) issued several new insurance regulations, including ones directed at the regulation of foreign insurance companies. These regulations implemented many of China's commitments, but they also created problems in three critical areas – capitalization requirements, transparency and branching. In particular, China's capitalization requirements were significantly more exacting than those of other populous countries, and they limited the ability of foreign insurers to make necessary joint venture arrangements. The regulations also continued to permit considerable bureaucratic discretion and to offer limited predictability to foreign insurers seeking to operate in China's market.

With regard to branching, China scheduled a commitment to allow non-life firms to establish as a branch in China upon accession and to permit internal branching in accordance with the lifting of China's geographic restrictions. China further agreed that foreign insurers already established in China that were seeking authorization to establish branches or sub-branches would not have to satisfy the requirements applicable to foreign insurers seeking a license to enter China's market.

China's regulations regarding foreign insurers' branching rights, however, remain vague, and CIRC has so far insisted that non-life insurers that are already in the market as a branch and that wish to branch or sub-branch cannot do so unless they first establish as a subsidiary, a costly condition. Further complicating this issue, CIRC has apparently waived this requirement for at least one foreign non-life insurer, but has not explained how or whether other foreign insurers could apply for this waiver.

In May 2004, CIRC took steps to address concerns related to China's high capitalization requirements by issuing the *Detailed Rules on the Regulations for the Administration of Foreign-Invested Insurance Companies*. These rules lowered capital requirements for national licenses from RMB 500 million ($60 million) to RMB 200 million ($24 million) and for branch offices from RMB 50 million ($6 million) to RMB 20 million ($2.4 million). These changes have been welcomed by some U.S. insurers, but others still consider them to be too high. The rules also streamlined licensing application procedures and shortened approval times, although some procedures remain unclear. Meanwhile, the rules did not adequately address branching rights, as many aspects of this issue remain vague.

By December 2004, in accordance with its WTO commitments, China lifted all of its geographic restrictions on foreign insurers. China also took steps in 2005 to permit foreign insurers to offer health and group insurance as well as pension/corporate annuities and increased the 50 percent ceiling on foreign ownership of joint venture insurance brokerages to 51 percent.

With all geographic restrictions removed and most business scope restrictions lifted in 2005, the operations of foreign insurers in China continued to grow. Foreign insurer premium income more than doubled, increasing from $1.2 billion in 2004 (representing 2.3 percent of total premium income) to $4.3 billion in 2005 (representing 6.9 percent of total premium income). While foreign insurers still had a relatively low share of the national market, in some areas market share was increasing more quickly. According to the most recently available figures from CIRC, in 2004, the 37 foreign insurers present in China (a figure that rose to 40 in 2005) held a 15.3 percent market share in Shanghai and an 8.2 percent market share in Guangzhou.

However, despite these developments, U.S. and other foreign insurers are concerned that apparent discrimination in branching approvals may limit their ability to expand. In practice, it appears that established Chinese insurers are being granted new branch approvals on a concurrent basis, meaning more than one branch at a time. In contrast, foreign insurers so far have only received approvals on a consecutive basis, meaning one branch at a time. Meanwhile, a number of U.S. investors have taken significant minority equity stakes in major Chinese insurance companies as a means of accessing China's insurance market.

Banking Services

As part of its WTO accession agreement, China agreed to allow foreign banks to conduct local currency business with Chinese companies two years after its WTO accession and with Chinese individuals five years after accession, or by December 11, 2006. China also committed to opening four new cities every year where foreign banks could engage in local currency operations. All non-prudential market access and national treatment restrictions on foreign banks are to be lifted by December 11, 2006.
Under regulations issued in December 2001, foreign banks must meet stringent criteria such as having gross assets of $20 billion when opening new branches in China. Although China reduced capital requirements for foreign bank branches in December 2003, they remained excessively high, increasing local capital costs for foreign banks. Foreign bank branches must also place 30 percent of their operating capital in interest bearing assets designated by the People's Bank of China (PBOC). Foreign bank branch current assets (cash, local bank demand deposits, and PBOC deposits) must continue to be greater than 25 percent of customer deposits. In addition, the ratio of customer deposits in foreign currency to domestic foreign currency assets may not exceed 70 percent, an increase from the 40 percent-level mandated previously. China calculates prudential rations and limits based on the local capital of foreign bank branches rather than on the global capital base of the bank, although more lenient rules apply in authorized cities in the northeastern and western regions of China.

China also continues to have strict limitations on foreign banks' participation in local currency operations, which are regulated by the PBOC. These restrictions are being gradually relaxed, but local currency transactions with individuals remain prohibited until December 11, 2006. Restrictions on the rights of foreign banks to raise RMB in the interbank market also inhibit the ability of foreign banks to build RMB loan portfolios necessary for profitable operations in China. Meanwhile, although foreign currency business with any customer, foreign or domestic, is now freely permitted, only a limited number of foreign banks are allowed to do forward foreign exchange contracts.

In December 2003, the Chinese Government increased the stake a single foreign investor can take in a Chinese bank from 15 to 20 percent, with a total 24.9 percent allowed for all foreign investors. The United States and other WTO members have objected to these limitations, as China did not schedule any limitation on the percentage of foreign ownership in these banks when it acceded to the WTO.

Nevertheless, since the increased ownership limitations went into effect, a number of foreign investors have taken significant equity stakes in Chinese banks, including three of the four large state-owned banks. In the case of the Shenzhen Development Bank, a foreign investor has been allowed to take a controlling interest. Two of the foreign-invested banks have successfully listed on the Hong Kong stock exchange and more are expected in the near future.

By October 2005, despite high capital requirements and other impediments, 173 foreign banks, including a number of U.S. banks, reportedly had branches or representative offices in China, although only major banks have been large enough to satisfy the application requirements. In addition, the business that foreign banks were most eager to pursue in China – domestic currency – had expanded tremendously, although China's regulatory authorities continued to shield domestic banks from foreign competition in some areas, such as by limiting product innovation by foreign banks. According to the PBOC and CBRC, the domestic currency business of U.S. and other foreign banks grew rapidly in the first two years after China's WTO accession, even though the banks' clients were then limited to foreign-invested enterprises and foreign individuals. Following the PBOC's December 2003 announcement that foreign banks would be permitted to conduct domestic currency business with Chinese enterprises subject to previously permitted geographic restrictions, the growth in U.S. and other foreign banks' domestic currency business accelerated. The total assets of foreign banks in China reportedly had reached $84.5 billion by October 2005, representing approximately 2 percent of the total banking assets in China. In some coastal cities, the share was higher. For example, in Shanghai, foreign banks' assets reportedly represented 12.4 percent of total banking assets.

Securities Services

Pursuant to the terms of China's WTO accession agreement, foreign securities firms were to receive the right to form joint ventures for fund management upon China's accession to the WTO in December 2001, while joint ventures for securities underwriting were to be permitted within three years after accession.

The China Securities Regulatory Commission issued regulations on the establishment of joint venture fund management companies and securities underwriting by Chinese-foreign joint ventures shortly after China's WTO accession. China's decision to limit foreign partners to a minority stake of these joint ventures (49 percent for fund management and 33 percent for securities trading), however, continues to limit their appeal to leading foreign firms and only a handful of joint ventures have been formed. In addition, China continues to limit the security underwriting joint ventures to underwriting A-shares and to underwriting and trading government and corporate debt, B-shares and H-shares.

Since December 2002, China has allowed Qualified Foreign Institutional Investors (QFIIs) to trade in A-shares via special accounts opened at designated custodian banks. However, stringent criteria currently make it difficult for foreign institutions to qualify as QFIIs, while other requirements limit the extent to which QFIIs can trade in A-shares.

Motor Vehicle Financing Services

China's WTO accession agreement required China to allow foreign non-bank financial institutions to provide motor vehicle financing immediately upon its accession in December 2001 and without any limits on market access. As a result of persistent U.S. engagement with China, both bilaterally and at WTO meetings, China issued regulations in October and November 2003 allowing foreign non-bank financial institutions to provide motor vehicle financing. The capital requirements set by these regulations are relatively high, with minimum registered capital at RMB 300 million ($36 million), and minimum paid-in capital at RMB 500 million ($60 million). In January 2004, CBRC granted licenses for one U.S. auto company and two other foreign auto companies to set up non-bank motor vehicle financing institutions. CBRC granted licenses for other foreign auto companies later in the year as well. In August 2004, the PBOC and CBRC jointly issued the *Administrative Rules on Auto Financing*, which became effective in October 2004. These rules set forth administrative requirements and risk management rules for extending auto loans in China and allowed the licensed companies to actually begin operations.

Financial Information Services

In its WTO accession agreement, as discussed above, China committed that, for the services included in its Services Schedule, the relevant regulatory authorities would be separate from, and not accountable to, any service suppliers they regulated, with two specified exceptions. One of the services included in China's services schedule – and not listed as an exception – is the "provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services."

Nevertheless, China has still not established an independent regulator in the financial information services sector. Xinhua, the Chinese state news agency, is both a major market competitor of, and the regulator of, foreign financial information service providers in China. As problems with Xinhua's regulation of this sector mounted in 2005, U.S. and other foreign financial information service providers began to call for the establishment of an independent regulator.

Wholesaling Services and Commission Agents' Services

In its WTO accession agreement, China committed to provide national treatment and eliminate market access restrictions for foreign enterprises seeking to provide wholesaling and commission agents' services and related services, such as repair and maintenance services, through a local presence within three years of China's accession (or by December 11, 2004), subject to limited product exceptions. In the meantime, China agreed to progressively liberalize its treatment of these services pursuant to a set schedule. The phase-in of these services was supposed to start with minority foreign-owned joint ventures by December 11, 2002, followed by majority foreign-owned joint ventures by December 11, 2003.

Shortly after acceding to the WTO, China fell behind in its implementation of the required progressive liberalization, as foreign enterprises continued to face a variety of restrictions. It was not until mid-2004, following high-level U.S. engagement that China began to take steps to

liberalize. At that time, MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing wholesaling services and commission agents' services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004.

While these regulations were welcome, MOFCOM was very slow to implement them, and it still has not implemented them fully. Initially, MOFCOM did not issue any guidance regarding how its approval system would operate, and the application process remained opaque. In most instances, the application process turned into a protracted negotiation, as the central and local approving authorities were still in the process of determining the appropriate procedures and documentation requirements. When approvals were issued, moreover, the central and local approving authorities imposed a variety of restrictions, such as limits on the scope of products that could be distributed and limits on the specific services that could be supplied. Registered capital requirements have also varied.

In addition, through the first six months of 2005, the Chinese authorities rarely issued approvals for existing enterprises seeking to expand their business scope to include wholesale distribution, in part because the Chinese authorities were sorting our historical tax treatment and Free Trade Zone (FTZ) issues. The Chinese authorities did issue some approvals for the establishment of new wholesale distribution enterprises, but this route did not make business sense for many enterprises already established in China.

By June 2005, the Chinese authorities had begun to make progress in resolving many of the problems that had plagued the application and approval process, including how it would handle the tax and FTZ issues that had stalled many enterprises' applications. In July 2005, MOFCOM and the General Administration of Customs (Customs Administration) issued the Circular on Issues Concerning the Trade Administration of Bonded Zones and Bonded Logistics Parks, which clarified the handling of applications from enterprises located in FTZs. At the July 2005 JCCT meeting, China also committed to improve the transparency of the application and approval process. Consistent with this commitment, in September 2005, MOFCOM issued the Application and Approval Guidelines for Foreign Investments, which clarify many aspects of the application and approval process. Since then, some improvements have taken place in the application and approval process, although U.S. industry continues to have concerns with regard to continuing product and services restrictions. U.S. industry is also concerned about the uncertainty created by the provision in the April 2004 regulations that allows the local approving authorities to withhold wholesale (and retail) distribution license approvals when, as is the case in most cities, urban commercial network plans have not yet been formulated. This provision could operate as a de facto restriction on the operations of foreign wholesalers (and retailers).

One area that requires clarification from the Chinese authorities involves the distribution of books, newspapers and magazines. While the April 2004 regulations purport to allow foreign enterprises to obtain the right to distribute books, newspapers and magazines in China, other measures appear to restrict this right.

For example, the *Administrative Measures on the Subscription of Imported Publications*, issued by the General Administration of Press and Publications in September 2004, appear to restrict the distribution of imported publications by subscription to state trading enterprises. While China has since confirmed that foreign enterprises are now permitted to distribute books, newspapers and magazines in China, it has not provided a justification for the measure that restricts the distribution of imported publications by subscription to state trading enterprises.

In 2005, China began to implement several measures designed to implement its commitment to allow the distribution of automobiles by foreign enterprises, including the *Implementing Rules for the Administration of Brand-Specific Automobile Dealerships,* the *Policies for Automobile Trade* and the *Measures for the Administration of the Distribution of Used Vehicles.* However, under these rules, foreign cars face more, not fewer, restrictions, especially in the area of dealerships. For example, foreign automobile manufacturers are required to delegate the operations of its distribution network to either a domestic firm or a newly created firm. Moreover, prior to December 11, 2006, foreign investors cannot hold more than 49 percent of any new dealership if it already owns thirty or more dealerships. Dealerships, post-sales service and supply of parts are all restricted to delegated operators.

Meanwhile, China has delayed the implementation of its commitments with regard to the distribution of pharmaceuticals, despite the fact that the exception for pharmaceuticals contained in China's accession agreement expired as of December 11, 2004. Although the April 2004 regulations indicated that separate regulations would be issued for the pharmaceuticals sector, China has not issued any further regulations and has continued to require foreign pharmaceutical companies to sell their finished products through Chinese wholesalers (after hiring Chinese importers to bring their finished products into the country). China reportedly decided in the last half of 2005 to begin accepting applications from foreign pharmaceutical companies for wholesale (and retail) licenses under the April 2004 regulations and the State Food and Drug Administration's *Rules on the Management of Drug Business Licenses*.

Retailing Services

In 1999, the Chinese government broadened the scope for foreign investment in the retail sector. New regulations encouraged the entry of large international retailers (such as hypermarkets and warehouse-style stores) into China. China's subsequent WTO commitments were designed to further expand the ability of foreign retailers to enter the market through a much wider range of modalities. Smaller retail operations, some large retail operations, gas stations and even car dealerships may be wholly foreign-owned within three to five years of China's December 2001 WTO accession, although certain types of large retail operations may still face ownership limitations.

As in the area of wholesaling and commission agents' services, China fell behind in its implementation of the required progressive liberalization of retailing services shortly after acceding to the WTO, as foreign enterprises continued to face a variety of restrictions.

China only began to take steps to liberalize in mid-2004, when MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing retailing services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004.

Many of the same problems that plagued the application and approval process for wholesaling and commission agents' services in 2005 also arose in the area of retailing services. While improvements took place throughout the year, U.S. industry continues to have concerns, particularly with regard to the provision in the April 2004 regulations allowing the local approving authorities to withhold retail distribution license approvals when, as is the case in most cities, urban commercial network plans have not yet been formulated.

Meanwhile, it appears that China may not be fully implementing its commitment to allow foreign enterprises to sell gasoline at the retail level. Although China's retail services commitments initially did not apply to processed oil, as it was one of the excepted goods under China's services schedule, that exception expired on December 11, 2004, and by that time China committed to permit wholly foreign-owned enterprises to operate gas stations. However, according to some recent reports, China is now claiming that gas stations fall under the chain store provision in its services schedule, which applies to "those chain stores which sell products of different types and brands from multiple suppliers with more than 30 outlets" and permits only joint ventures with minority foreign ownership.

Franchising Services

As part of its services commitments, China committed to permit the cross-border supply of franchising services immediately upon its accession to the WTO. It also committed to permit foreign enterprises to provide franchising services in China, without any market access or national treatment limitations, by December 11, 2004. In December 2004, MOFCOM issued new rules governing the supply of franchising services in China, the *Measures for the Administration of Commercial Franchises*, effective February 2005. These rules raised a number of concerns. Of particular concern is a requirement that a franchiser own and operate at least two units in China for one year before being eligible to offer franchises in China. The business models of many U.S. franchising companies, including some large hotel chains, are adversely affected by this requirement because they do not own and operate units, instead relying exclusively on franchisees to distribute goods and services. The rules also impose high capital requirements and require broad and vague information disclosure by franchisers, with uncertain liability if these disclosure requirements are not met.

Sales Away From a Fixed Location

In 1998, China banned all direct selling activities (or sales away from a fixed location) activities after some foreign and domestic firms used direct selling techniques to operate fraudulent pyramid schemes and other less-than-legitimate operations disguised as direct selling to bilk participants. No U.S. firms were implicated in these schemes. Meanwhile, some large U.S. and other foreign direct selling firms were allowed to continue operating in China after altering their business models. In its WTO accession agreement, China committed to the resumption of direct selling activities by December 2004.

In September 2005, nine months overdue, the Chinese authorities issued the measures designed to implement China's direct selling commitments – the *Measures for the Administration of Direct Selling* and the *Regulations on the Administration of Anti-Pyramid Sales Scams*. These measures contained several problematic provisions. For example, one provision outlaws practices allowed in every country in which the U.S. industry operates – reportedly 170 countries in all – by refusing to allow direct selling enterprises to pay compensation based on team sales, where upstream personnel are compensated based on downstream sales. The United States has pointed out that China could revise this provision to permit team-based compensation while still addressing its legitimate concerns about pyramid schemes. Other problematic provisions include a three-year experience requirement that only applies to foreign enterprises, not domestic ones, restrictions on the cross-border supply of direct selling services and high capital requirements that may limit smaller direct sellers' access to the market. These measures also forbid foreigners from working as salespersons or as trainers for salespersons.

Express Delivery Services

Beginning in December 2001, the State Postal Bureau (together with MOFTEC and MII) issued restrictive measures that could have jeopardized market access that foreign express delivery firms (which were then required to operate as joint ventures with Chinese partners) enjoyed prior to China's accession. These measures threatened to curtail the scope of operations of foreign express delivery firms licensed prior to China's accession to the WTO, despite China's horizontal commitment on acquired rights. Specifically, a measure issued in December 2001 required firms wishing to deliver letters to apply for entrustment with China Post. A second measure, issued in February 2002, extended China Post's monopoly on letters by creating weight and rate restrictions on letter deliveries by private firms. Following high-level U.S. interventions, in September 2002, a third measure eliminated the weight and rate restrictions on letter deliveries and streamlined the entrustment application procedure. Two major U.S. express delivery firms subsequently applied for and obtained entrustment certificates from China Post.

In July 2003, however, China circulated draft amendments to its postal services law that generated two immediate concerns among U.S. companies. First, the draft amendments purported to give China Post a monopoly over the delivery of letters under 500 grams, which would have constituted a new restriction on the scope of activities of existing foreign-invested express delivery companies, contrary to China's horizontal acquired rights commitment. Second, the draft amendments did not address the need for an independent regulator.

In September, October and November 2003, China circulated new sets of draft amendments. While each set of draft amendments included a different definition of the China Post monopoly, the most recent draft amendments continued to provide China Post with a monopoly on letters weighing less than 500 grams. They also included other problematic provisions. For example, they appeared to create a new, more burdensome licensing process, and they seemed to require express couriers to pay a percentage of their revenue from the delivery of letters into a universal service fund.

In April 2004, following high-level U.S. engagement urging China not to cut back on the scope of activities that foreign-invested express delivery companies had been licensed to provide prior to China's WTO accession, Vice Premier Wu Yi committed that old problems, like the weight restriction, would not resurface as new problems. In July 2004, however, the State Council circulated another set of draft amendments to the postal services law. Despite Vice Premier Wu's commitment, these draft amendments continued to include a weight restriction, now reduced from 500 grams to 350 grams and did little to address other U.S. concerns. A new but still problematic set of draft amendments was reportedly circulating within China's ministries and agencies and to select domestic enterprises in early 2006, as U.S. engagement continued.

Construction, Engineering, Architectural and Contracting Services

Since before China's WTO accession, U.S. construction, engineering and architectural firms and U.S. contractors have enjoyed a relatively cooperative and open relationship with the Chinese government. These firms have operated in the Chinese market through joint venture arrangements and have been less affected by regulatory problems than other service sectors. Nevertheless, they have also faced restrictions. It has been difficult for foreign firms to obtain licenses to perform services except on a project-by-project basis. Foreign firms have also faced severe partnering and bidding restrictions.

In September 2002, the Ministry of Construction and MOFTEC jointly issued Decrees 113 and 114, which opened up construction and related construction design services to joint ventures with majority foreign ownership and, two years ahead of schedule, wholly foreign-owned enterprises. At the same time, however, these decrees created concerns for U.S. and other foreign firms by imposing new and more restrictive conditions than existed prior to China's WTO accession, when they were permitted to work in China on a project-by-project basis pursuant to Ministry of Construction rules. In particular, these decrees for the first time required foreign firms to obtain qualification certificates, effective October 1, 2003. In addition, these decrees for the first time required foreign-invested firms supplying construction services to incorporate in China, and they impose high minimum registered capital requirements and foreign personnel residency requirements that are difficult for many foreign firms to satisfy. In consultation with U.S. industry, the United States, in a high-level intervention, pressed its concerns about Decrees 113 and 114 and sought a delay before the decrees' problematic requirements would become effective. In September 2003, the Ministry of Construction agreed to extend the implementation date from October 1, 2003 until April 1, 2004 so the concerns of foreign firms could be analyzed further.

In April 2004, Decree 113 went into effect. However, in September 2004, the Ministry of Construction and MOFCOM issued Circular 159, which permitted foreign providers of construction services and related construction engineering design services to continue operating on a project by-project basis until July 1, 2005, effectively extending the effective date of the incorporation-related requirements. With the expiration of Circular 159 in July 2005, however, U.S. and other foreign companies now face a great deal of uncertainty as they seek to participate in projects in China.

In September 2005, the Ministry of Construction and MOFCOM circulated draft *Regulations on the Administration of Foreign-Invested Construction Service Enterprises* for public comment. These draft regulations call for the Chinese authorities to begin accepting applications from foreign-invested enterprises on December 1, 2006. While the draft regulations bring clarity to the application and approval process, they fail to address foreign companies' concerns regarding high capital requirements and recognition of foreign credentials. They also create obstacles and delay for foreign companies by establishing a complicated grading system for construction service enterprises.

Meanwhile, in late November 2004, the Ministry of Construction issued the *Provisional Measures for Construction Project Management* (known as Decree 200), which became effective on December 1, 2004. Among other things, Decree 200 appears to preclude the same company from providing construction services and related construction engineering design services if it also provides project management services on the same project. This aspect of the decree raises concerns because U.S. companies often provide all of these services in combination when working on a project in a foreign market.

Finally, a number of restrictions continue to apply to foreign providers of engineering and architectural services. Foreign firms cannot hire Chinese nationals to practice engineering and architectural services as licensed professionals. Currently, Chinese engineering and architectural firms must approve and stamp all drawings prior to construction. China also sets extremely low design fees, rather than letting the market set prices, while China does not have adequate lien laws to protect the rights of engineering and architectural firms from non-payment. There have also been instances in which U.S. engineering and architectural firms have had to pay Chinese domestic taxes on designs prepared in the United States for Chinese projects.

Transportation and Logistics Services

The transportation and logistics sector has in the past faced severe regulatory restrictions, high costs, dominance by government-invested agents, and limitations on permitted activities. The multiple government bodies responsible for this sector include the Ministry of Communications, the Ministry of Railways, MOFCOM, NDRC and the Civil Aviation Administration of China. Overlapping jurisdictions, multiple sets of approval requirements and opaque regulations hinder market access. In some areas, domestic firms have also used government connections and investments to monopolize the sector.

Nevertheless, like China's own reform policies, China's WTO commitments support a broad opening of the transportation and logistics sector to foreign services providers, to be phased in over time. Foreign firms should be able to invest freely in warehousing, road freight transport, rail freight transport and freight forwarding companies within three to six years after WTO accession, depending on the sector.

In July 2002, MOFCOM's predecessor, MOFTEC, issued a *Notice on Establishing Foreign-Invested Logistics Companies in Trial Regions*. This notice allows foreign-invested logistics companies (with up to 50 percent foreign ownership and registered capital of $5 million) to establish in several designated cities. U.S. firms have expressed concern about the high capital requirement and the 50 percent cap on foreign ownership, which may conflict with China's WTO commitments for certain types of logistics services.

In November 2002, China issued regulations allowing majority foreign ownership of road transportation firms, as it was required to do within one year of its WTO accession. China was also obligated to issue regulations allowing majority foreign-owned joint ventures to enter the fields of packaging services, storage and warehousing, and freight forwarding one year after its accession; it issued timely regulations allowing 75 percent foreign-owned joint ventures in these fields.

China took a significant step in July 2004 to increase market access for U.S. passenger and cargo carriers by signing a landmark amendment to the aviation agreement with the United States. The amended agreement will more than double the number of U.S. airlines operating in China and will increase by five times the number of flights providing passenger and cargo services between the two countries over the next six years. The agreement also allows each country's carriers to serve any city in the other country, provides for unlimited code-sharing between them, expands opportunities for charter operators, and eliminates government regulation of pricing as of 2008. U.S. passenger and cargo carriers have since obtained additional routes and increased flight frequencies, as envisioned by the agreement.

Similarly, in late 2003, China took steps to liberalize the maritime services sector despite having made no WTO commitment. The United States and China signed a far-reaching, five-year bilateral maritime agreement, which will give U.S.-registered companies the legal flexibility to perform an extensive range of additional shipping and logistics activities in China. U.S. shipping and container transport services companies, along with their subsidiaries, affiliates and joint ventures will also be able to establish branch offices in China without geographic limitation.

In April 2005, AQSIQ issued the *Criteria for the Classification and Assessment of Logistics Firms*. Under this measure, AQSIQ uses a firm's business and financial situation, equipment, operating infrastructure, management, services provided, and human resource information as of the time of its business license application in order to classify the firm into one of three broad categories, i.e., transport, warehouse or multi-service, for regulatory purposes.

Some firms have criticized this measure as creating "hastily formulated standards" that inappropriately restrict the business scope of logistics firms and have also complained about unnecessary and burdensome requirements. In addition, freight forwarding firms are concerned about not being included in one of the three logistics business categories, particularly because it may prevent their participation in relevant standards-setting activities.

Telecommunications

In its WTO accession agreement, China made important commitments in the area of telecommunications services. It agreed to permit foreign suppliers to provide a broad range of services through joint ventures with Chinese companies, including domestic and international wired services, mobile voice and data services, value-added services, such as electronic mail, voice mail and on-line information and database retrieval, and paging services. The foreign stake permitted in the joint ventures is to increase over time, reaching a maximum of 49 percent for most types of services. In addition, China agreed to eliminate all geographical restrictions within two to six years after its WTO accession, depending on the particular service sector.

Importantly, when it acceded to the WTO, China also accepted key regulatory principles from the WTO Reference Paper. As a result, China became obligated to separate the regulatory and operating functions of MII (which had been both the telecommunications regulatory agency in China and the operator of China Telecom) upon its accession and to implement its regulations in an impartial manner. Since China's accession, MII has spun-off China Telecom, which now competes in the market with other telecom operators. While the formal separation of regulator and operator has occurred, evidence of continued MII influence over operational decisions of the telecom operators (e.g., relating to personnel, corporate organization and standards) suggests that regulatory independence is far from complete. The current regulator, MII, is not structured as an independent entity as it still bears the responsibility to help develop China's IT and telecom manufacturing industries.

China is also obligated to adopt pro-competitive regulatory principles, such as transparent licensing, cost-based pricing and the right of interconnection, which are necessary for foreign-invested joint ventures to compete against established operators. China appears laggard in implementing these commitments, however. For example, there is no sign that "major suppliers" in China have made their interconnection arrangements public. With practically no foreign participation in the market, it has been difficult to assess compliance with such commitments. This very lack of foreign participation, however, is indicative of a licensing regime that has not been conducive to foreign investment, in part due to lack of transparency.

China's *Regulations on Foreign-Invested Telecommunications Enterprises* went into effect January 1, 2002. These regulations define registered-capital requirements, equity caps, requirements for Chinese and foreign partners, and licensing procedures. The regulations stipulate that foreign-invested telecommunications enterprises can undertake either basic or value-added telecommunications services. Foreign ownership may not exceed 49 percent in the case of basic telecommunications services (excluding wireless paging) and 50 percent in the case of value-added services (including wireless paging, which is otherwise categorized as a basic service). The entire process of forming a Sino-foreign joint venture for basic services pursuant

to the new regulations is believed to be lengthy, lasting on average 9 to 12 months. While China committed to giving foreign applicants freedom to choose potential joint venture partners, it appears that MII is interpreting requirements regarding technical qualifications to effectively exclude all but incumbent operators, foreclosing additional competition in the market. For foreign operators interested in offering international services, requirements to use a gateway operated by a state-owned operator appear excessive and unjustified. The capitalization requirement established for new entrants, which exceeds $200 million, is another major impediment to market access. There appears to be no justification for such a requirement, particularly for companies interested in leasing, rather than building facilities, while specific licensing terms for resale-based operators do not appear to exist. Meanwhile, MII continues to process applications very slowly for the few foreign-invested telecommunications enterprises that have attempted to satisfy MII's licensing requirements. The results have been predictable: no new joint ventures appear to have been formed in the basic telecom sector since China introduced the January 2002 regulations.

At times, MII has also changed applicable rules without notice and without transparency. For example, in February 2003, MII announced a reclassification of certain basic and value-added telecommunications services effective April 1, 2003. No public comment period was provided. This move limited the ability of U.S. firms to access China's telecommunications market because basic services are on a slower liberalization schedule and are subject to lower foreign equity limits and higher capitalization requirements.

Little progress has been made in opening the market for value-added services, such as Internet service and content providers. MII announced moves toward convergence in voice, video and data services in 2000, but China considers information content sensitive, so foreign companies face significant barriers in the Internet services sector. Although more foreign companies are registering ".com.cn" websites in China, these sites are still often blocked, which hinders companies' abilities to maintain a stable Internet presence. The requirement that Internet service providers (ISPs) must provide user login information and transaction records to authorities upon request, without clear guidelines as to the circumstances and situations that warrant such actions, raises concerns about consumer privacy and prevention of data misuse. Meanwhile, even though China has now completed its fourth year of WTO membership, the United States is aware of only one application for a license to provide value-added services that has completed the MII licensing process. That license was awarded to a Chinese-Korean joint venture in 2005.

Foreign equity investment limitations for ISPs and Internet content providers (ICPs) mirror the timetable for value-added services in China's WTO accession agreement (30 percent upon accession, 49 percent within one year after accession and 50 percent within two years after accession). However, ICPs must still win the approval of MII and/or local telecom administrations depending on the geographic coverage of their services before they can receive foreign capital, cooperate with foreign businesses, or attempt domestic or overseas stock listings. Their services, including even simple commercial websites, are also subject to excessive capitalization requirements that bear little relation to any legitimate licensing goals.

In 2004, a draft of the long-awaited Telecommunications Law began to circulate among Chinese ministries and agencies. If China takes the initiative, this law could be a vehicle for addressing existing market access barriers and other problematic aspects of China's current telecommunications regime. The current status and content of this legislation is unclear, despite repeated U.S. efforts to obtain this information.

Meanwhile, even though China committed in its WTO accession agreement that further liberalization of this sector would be discussed in the current round of WTO negotiations, China has yet to make an improved services offer. With the modest telecommunications commitments made by China in its WTO accession agreement having so far failed to facilitate effective market entry for foreign firms, further liberalization, bound through the current round of WTO negotiations, appears critical to improving market access prospects for this sector.

On-Line Services

Chinese authorities routinely filter Internet traffic entering China, focusing primarily on the content they deem objectionable on political, social or religious grounds. In 2002, China lifted filters on most major western news sites. Nevertheless, since then, foreign news websites have periodically been blocked, as happened, for example, for several weeks during the 16th National Congress of the Communist Party of China in 2003. More generally, according to a Harvard University study published in 2002, China had still blocked 19,032 sites on multiple occasions. In addition to blocking sites related to Taiwan, the Falun Gong spiritual movement, Tibetan and Uighur support groups and human rights organizations focusing specifically on China, the study states that China repeatedly blocked university alumni homepages such as MIT's homepage, various church and other religious-themed sites and search engines such as Alta Vista. Changes to Internet filtering can occur without warning or public explanation. For example, the popular Internet search engine Google was blocked completely in China for a few weeks starting in late August 2002. When Google became available again in September 2002, its "cached pages" feature remained blocked; that feature had previously allowed users in China to access "snapshots" of some web pages that were otherwise blocked in China. All of these practices remained prevalent in 2005. Few, if any, websites related strictly to economic and business matters, however, are blocked.

Internet content restrictions for ICPs, electronic commerce sites and application service providers located in China are governed by a number of measures, not all of which are public. Some of these measures restrict who may report news and place limits on what exactly may constitute news. The most important of these measures was issued in September 2000 and updated in September 2005. In addition to interfering with news reporting in the traditional sense, this measure may provide a basis for Chinese authorities to interfere with the normal business reporting operations of non-news organizations, such as multinational corporations, if they use the Internet to keep clients, members, their headquarters and other interested parties informed about events in China.

In March 2002, the Internet Society of China, a nominally private group affiliated with MII, established a "Public Pledge on Self-Discipline for the China Internet Industry." Signatories commit to "refrain from producing, posting or disseminating pernicious information that may jeopardize state security and disrupt social stability, contravene laws and regulations and spread superstition and obscenity." Reportedly, 130 major Internet portals have since signed the pledge.

Audio-Visual Services (Including Film Imports)

China's *Regulations on the Administration of Audio-Visual Products and Regulations on the Management of Film* went into effect on February 1, 2002. They are designed to bring more order and transparency to the film and audio-visual industries, with an eye to moving toward greater commercial efficiency in accordance with domestic reform efforts and China's WTO commitments. Despite these positive moves, China's desire to protect the revenues earned by the state-owned movie and print media importers and distributors, and China's concerns about politically sensitive materials, result in continued restrictions on foreign providers of audio-visual services. For example, distribution of sound recordings, videos, movies, books and magazines remains highly restricted. In addition news services remain wary that the Chinese government will impose new restrictions on their activities. Inconsistent and subjective application of censorship regulations further impedes market growth for foreign and domestic providers alike.

China issued a number of regulations in 2004 that should lead to expanded market access in the audio-visual services sector, although many restrictions remain. In July 2004, the State Administration for Radio, Film and TV (SARFT) issued the *Rules for the Administration of China-Foreign Cooperation in Filmmaking*. According to these rules, licenses are required for both the joint Chinese-foreign filmmaking cooperative and the cooperating domestic partner. In October 2004, SARFT and MOFCOM issued the *Provisional Rules on the Access Requirements for Film*. These rules cover film production, distribution, screening and imports by domestic firms, and film production and screenings involving foreign firms. All firms engaged in these businesses are subject to SARFT licensing. Foreign firms are allowed to form joint ventures and cooperative firms engaged in film production, technology and equipment. Joint ventures or cooperative firms must have at least RMB 5 million ($600,000) of registered capital, and foreign capital cannot make up more than 49 percent of the total share. In October 2004, SARFT and MOFCOM issued the *Provisional Rules on the Administration of China-Foreign Joint Venture and Cooperative TV Program Production Firms*. These rules establish a minimum registered capital requirement of RMB 2 million ($240,000) for joint ventures and cooperative firms and mandate a share of no less than 51 percent for domestic partners. In February 2005, SARFT issued a circular placing further restrictions on foreign partners and requiring two-thirds of the programs of a joint venture or cooperative firm to have Chinese themes. Finally, in August 2005, the State Council issued a directive stating that non-public capital cannot be used to establish or operate a news agency, newspaper, publishing house, radio station, or TV station. The directive also stated that radio and television signal broadcasting and relay station, satellite and backbone networks are closed to non-public capital.

China began importing foreign films on a revenue-sharing basis in 1994. The Chinese government limits the number of foreign films allowed to enter China. China allowed in only ten foreign films annually through much of the 1990s, but more recently allowed in 20 foreign films annually on a revenue-sharing basis under its WTO commitments. However, China treats its WTO commitment as a ceiling, rather than a floor, which artificially increases demand for pirated products. Although China is also obligated to open theaters and film distribution to foreign investment, currently there are only two authorized distributors of foreign films, the state-owned China Film Distribution Company and Huaxia. Furthermore, lengthy censorship reviews by Chinese authorities delay the arrival of legitimately imported foreign films on Chinese movie screens. When the films do make it to the screen, they have sometimes been subject to blackout viewing periods during national holidays. China's large black market for foreign films continues to grow because these market access restrictions not only create a demand for pirated DVDs in the absence of legitimately licensed films, but also diminish the incentive for foreign investment in movie theaters (which is currently limited to a minority stake). Rights holders who comply with Chinese law must forego marketing legitimate products, leaving the demand for movies to be satisfied almost entirely by pirates. Some progress was achieved in 2004, when MOFCOM approved a U.S.-invested film distribution joint venture and took steps to shorten the time required to bring films to market.

Meanwhile, China is reportedly in the process of formulating a policy to support its weak cartoon industry. According to several reports, in June 2005, SARFT began circulating a draft measure providing that only domestically produced cartoons could be broadcast during prime-time viewing hours and that advertisements shown during this period should be used to finance the production of domestic cartoons. The draft measure also reportedly forbids the introduction of foreign cartoons under the disguise of domestic cartoons as well as cartoons that are jointly made with foreigners.

Tourism and Travel Services

Immediately following China's WTO accession in December 2001, China issued new travel agency administration regulations, the *Regulations on the Administration of Travel Agencies*, which were designed to make it easier for large foreign travel and tourism service providers to participate as minority partners in the operation of full-service joint venture travel agencies handling foreign inbound tourism. China subsequently issued the *Provisional Measures for the Establishment of Foreign-controlled and Wholly Foreign-funded Travel Agencies*, effective July 2003, which for the first time expressly allowed both foreign-controlled joint ventures and wholly foreign-owned enterprises. Under this measure, these travel agencies were allowed to engage in foreign inbound tourism through the establishment of offices in five major foreign tourist destinations in China – Beijing, Shanghai, Guangzhou, Shenzhen and Xian. Foreign-controlled travel agencies must have an annual worldwide turnover in excess of $40 million, and wholly foreign-funded travel agencies must have an annual worldwide turnover in excess of $500 million. For both types of travel agencies, there is also a local registered capital requirement of RMB 4 million ($480,000).

In November 2003, Germany's Touristic Union International (TUI) signed a letter of intent with the China Tourism Agency to form the first joint venture travel agency controlled by a foreign interest since China's WTO accession. Japan Airlines subsequently established the first wholly foreign-funded travel agency.

In February 2005, China issued a measure lowering the minimum registered capital requirement for foreign-controlled and wholly foreign-owned travel agencies from RMB 4 million ($480,000) to RMB 2.5 million ($300,000), which had been required as of December 11, 2004, by its WTO accession agreement. It also lifted all remaining geographical restrictions on the establishment of foreign-controlled and wholly foreign-owned travel agencies, nearly three years in advance of the schedule set forth in its WTO accession agreement.

Foreign firms continue to be restricted from competing in the Chinese outbound tourist market. In addition, China requires all travel agents, airlines and other booking entities to use or connect into China's nationally owned and operated computer reservation system when booking airline tickets. Foreign computer reservation companies can only provide reservations by connecting with the Chinese system. The total number of non-immigrant visas issued to Chinese wishing to travel to the United States rose from approximately 263,000 in FY 2004 (October 1, 2003-September 30, 2004) to more than 326,000 in FY 2005 (October 1, 2004-September 30, 2005), a 24 percent increase. Most of this increase is accounted for by a resumption of normal travel patterns following the containment of the SARS outbreak in China in 2003.

Beginning on January 15, 2005, eligible Chinese nationals wishing to visit the United States temporarily for business (B-1) or tourism (B-2) could be issued visas that were valid for 12 months and multiple entries. The previous maximum validity for U.S. visas issued for these purposes was six months and multiple entries.

Meanwhile, holders of official Chinese passports, nearly 23,000 of who were issued U.S. visas in 2004, are required to use China's state-owned airlines or their code-share partners. Most of these individuals are employees of state-owned enterprises, who would not be considered government employees in most countries. This represents a significant loss of business for U.S. airlines.

Education and Training Services

China faces a shortage of qualified teachers and clearly needs educators in inland regions. However, the Ministry of Education (MOE) continues to restrict participation by foreign educators and trainers. China permits only non-profit educational activities that do not compete with the MOE-supervised nine years of compulsory education, thereby inhibiting much-needed foreign investment in the education sector. In April 2000, MOE also banned foreign companies and organizations from offering educational services via satellite networks.

In June 2004, the Ministry of Education issued the *Implementing Rules for China-Foreign Cooperative Education Projects*. Although formulated to implement the *Regulations on China-Foreign Cooperation in Running Schools*, issued in September 2003, the rules allow foreign educators to participate only in certain activities, including education offering academic certificates, supplementary education and pre-school education. These activities cannot take the form of activities at actual educational institutions.

Foreign universities may set up non-profit operations. However, they must have a Chinese university host and partner to ensure that programs bar subversive content and localize imported information.

Meanwhile, China's training market is unregulated, which discourages potential investors from entering the market.

Legal Services

Prior to its WTO accession, China maintained various restrictions in the area of legal services. It prohibited representative offices of foreign law firms from practicing Chinese law or engaging in profit-making activities with regard to non-Chinese law. It also imposed restrictions on foreign law firms' formal affiliation with Chinese law firms, limited foreign law firms to one representative office and maintained geographic restrictions. Chinese law firms, on the other hand, have been able to open offices freely throughout China since 1996.

As part of its WTO accession, China agreed to lift quantitative and geographical restrictions on the establishment of representative offices by foreign law firms within one year after accession. In addition, foreign representative offices are to be able to engage in profit-making business, to advise clients on foreign legal matters and to provide information on the impact of the Chinese legal environment, among other things. They also are to be able to maintain long-term "entrustment" relationships with Chinese law firms and to instruct lawyers in the Chinese law firm as agreed between the two law firms.

The State Council issued the *Regulations on the Administration of Foreign Law Firm Representative Offices* in December 2001, and the Ministry of Justice issued implementing rules in July 2002. While these measures removed some market access barriers, they also generated concern among foreign law firms doing business in China. In many areas, these measures were ambiguous. For example, it appeared that these measures created an economic needs test for foreign law firms that want to establish offices in China, which would raise concerns regarding China's compliance with its GATS commitments. The measures also seemed to take an overly restrictive view of the types of legal services that foreign law firms may provide. In addition, the procedures for establishing a new office or an additional office were unnecessarily time-consuming. For example, a foreign law firm may not establish an additional representative office until its most recently established representative office has been in practice for three consecutive years. Foreign attorneys also may not take China's bar examination, and they may not hire registered members of the Chinese bar as attorneys.

Although a number of U.S. and other foreign law firms have been able to open a second office in China, little progress has been made on the other problematic aspects of these measures, particularly the economic needs test, the unreasonable restrictions on the types of legal services that can be provided and the unnecessary delays that must be endured when seeking to establish new offices. These obstacles continue to prevent foreign law firms from participating fully in China's legal market.

Accounting and Management Consultancy Services

Prior to China's accession to the WTO, foreign accounting firms could not choose their own Chinese joint venture partners freely or enter into contractual agreements that could fully integrate these joint ventures. Upon its accession to the WTO, China agreed to allow foreign accounting firms to partner with any Chinese entity of their choice. China also agreed to abandon the prohibition on foreign accounting firms' representative offices engaging in profit-making activities. In addition, China agreed that foreign accounting firms could engage in taxation and management consulting services, without having to satisfy the more restrictive requirements on form of establishment applicable to new entities seeking to provide those services separately.

The Chinese Institute of Certified Public Accountants, a government body under MOF, has made progress in modernizing accounting in China. In 2002, MOF released four newly revised auditing statements covering inter-bank confirmation, capital verification, accounting estimates and the audit of commercial bank financial statements. Furthermore, MOF has been active in standardizing accounting procedures across a wide range of topics including investments, inventories, cash flow statements, and fixed assets. The Chinese Securities Regulatory Commission, meanwhile, requires a listed company to appoint a certified international CPA firm to conduct audits on prospectuses and annual reports in accordance with international standards.

Despite these positive changes, pervasive problems remain. Differing accounting regulations limit the comparability of data, and the accounting practices followed by many domestic firms do not meet international conventions.

Advertising Services

In the past, foreign firms had been restricted to representative offices or minority ownership of joint-venture operations. As part of its WTO accession commitments, however, China agreed to allow majority foreign ownership of joint venture advertising companies by December 11, 2003, and wholly foreign-owned subsidiaries by December 11, 2005.

In March 2004, the State Administration of Industry and Commerce (SAIC) and MOFCOM issued rules governing joint venture, cooperative and wholly foreign-owned advertisement firms. To establish branches, a firm must have paid in full its registered capital and have at least RMB 20 million ($2.4 million) in annual advertising revenue. Foreign firms are currently limited to a 70 percent share of joint venture and cooperative firms. Implementing rules, effective January 1, 2005, subsequently allowed wholly foreign-owned advertising firms to conduct business in China.

Advertising in China is still governed by China's 1995 Advertising Law, which is enforced by SAIC. Among other things, the law bans messages "hindering the public or violating social customs." The law is also subject to interpretation by SAIC, which must approve all advertising campaigns. One additional difficulty for foreign advertising firms, as well as foreign manufacturers, is that China has strict regulations prohibiting comparative advertising as well as any advertising with claims about the relative superiority of one brand over another. Marketing strategies that are successful in some other countries are therefore illegal in China.

Movement of Professionals

Generally, there are no special entry restrictions placed on U.S. professionals who wish to work in China, such as doctors or engineers. However, like other foreign professionals, they must receive approval from the Foreign Experts Bureau. Prior to arrival, a prospective American job applicant may be asked to provide notarized copies of his or her professional credentials and a summary of past work experience. The credentials will be used by the employer to file for a "foreign experts residency permit" for the American employee. Once the "foreign expert" permit is authorized, the prospective employee can request a work visa (a "Z" visa) from a Chinese embassy or consulate. If the prospective employee arrives in China on a visitors' visa (an "L" visa) prior to commencing employment, the prospective employee is usually asked to depart China prior to starting work, and to apply for the appropriate work visa from a foreign entry point (usually Hong Kong). Local employers are responsible for all employment or income tax and other withholdings for these "foreign experts" while they are employed in China. Recent press reports indicate that the government is considering measures to liberalize access by issuing "permanent resident" visas to long-time foreign residents of China. Meanwhile, for long-term foreign residents in China, the government is liberalizing access by replacing the "Residence Card" with the "Permanent Resident Visa."

INVESTMENT BARRIERS

Foreign investors continue to show great interest in China despite significant obstacles. According to the United Nations Conference on Trade and Development, China received $60.3 billion in FDI in 2005, about 0.5 percent under the 2004 figure but still making China the third largest destination for FDI after the United States and the United Kingdom. Investors in China continue to confront a lack of transparency, inconsistently enforced laws and regulations, weak IPR protection, corruption and an unreliable legal system incapable of protecting the sanctity of contracts. In 2005, U.S. companies highlighted the inadequate supply of qualified management-level human resources and local protectionism as two new areas of concern, and noted that China's performance in both areas had deteriorated since 2004.

China's leadership has reaffirmed its commitment to "further open" China to investment and to continue movement toward a rules-based economic system. Meanwhile, foreign (and domestic) companies have continued to report high profitability in 2005, indicating that challenges to doing business in China have been largely surmountable. Nonetheless, faster progress toward removing investment barriers could spur even more investment, particularly in new, higher value-added manufacturing and services.

Investment Requirements

In addition to taking on the obligations of the WTO Agreement on Trade-Related Investment Measures, China committed in its WTO accession agreement to eliminate export performance, local content and foreign exchange balancing requirements from its laws and regulations and not to enforce any contracts imposing those requirements. China also agreed that it would no longer condition investment (or import) approvals on those requirements or on requirements such as technology transfer and offsets.

In anticipation of these commitments, China revised its laws and regulations on foreign-invested enterprises in an attempt to eliminate WTO-inconsistent requirements relating to export performance, local content and foreign exchange balancing as well as technology transfer. China also revised "Buy China" policies that regulated procurement of raw materials and fuels, and removed requirements that joint ventures and wholly foreign-owned enterprises submit production/operation plans to Chinese authorities. However, some measures continue to "encourage" technology transfer, without formally requiring it. U.S. companies are concerned that this encouragement will in practice amount to a requirement in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications. In addition, according to U.S. companies, some Chinese government officials still consider factors such as export performance and local content when deciding whether to approve an investment or to recommend approval of a loan from a Chinese bank, which is often essential to the success of an investment project.

Foreign investors remain wary of potential investment-related practices that would be inconsistent with WTO rules. In their experience, central government commitments to WTO-compliant measures often do not translate into provincial practices.

Investment Guidelines

Foreign investment inflows continue to be controlled and channeled toward areas that support national development objectives. China has adjusted its investment guidelines a number of times over the last several years. The revisions have confused potential investors and added to the perception that the investment guidelines do not provide a stable basis for business planning. Uncertainty as to which industries are being promoted as investment targets and how long such designations will be valid undermines confidence in the stability of the investment climate. The most recent catalogue of investment targets took effect January 1, 2005, replacing the April 2002 catalogue. Like its predecessor, it lists sectors in which foreign investment would be encouraged, restricted or prohibited. Investment in unlisted sectors is considered to be permitted.

Sectors in which China encourage investment include those in which China believes that it could benefit from foreign assistance or technology, such as construction and the operation of infrastructure facilities. In addition, the April 2002 catalogue had implemented elements of openings in sectors to which China committed in its WTO accession agreement, including banking, insurance, petroleum extraction, value-added telecommunications, and distribution. The January 2005 catalogue opens television program production and movie production to foreign investors by allowing minority participation in joint ventures. It also adds production of

certain components for large-screen color projection tubes, automobile electronics, industrial boilers and the manufacture of compact disc media to the list of encouraged investments, which benefit from duty-free import of capital equipment and VAT rebates on inputs.

Over the past several years, China has also introduced incentives for foreign investment in certain encouraged sectors. For example, China introduced incentives for investments in high-technology industries, such as a measure issued in November 1999 that provided foreign-invested enterprises a tax deduction for contributions to non-affiliated research and development or educational institutions. In December 2001, China announced comprehensive new incentives for investment in the less-developed central and western parts of the country. Other tax incentives include a reduction of income taxes for foreign-invested enterprises in targeted regions and special economic zones as well as for foreign-invested enterprises engaged in certain industries, such as machinery or construction.

The government also announced a series of measures in August 1999 that began to decentralize authority for approving investments and to create new incentives for investments in key sectors and geographic regions. These guidelines also expanded the authority of provincial-level governments to approve foreign-invested projects. The current rules, set forth in measures issued by the State Council in July and October 2004, significantly expanded provincial governments' approval authority. Under these measures, only project proposals in "encouraged" and "permitted" sectors valued above $500 million, and those in "restricted" sectors valued above $50 million, require NDRC review and State Council approval.

Meanwhile, the Chinese government restricts foreign investment projects in sectors not in line with "the needs of China's national economic development." In these sectors, foreign firms must form a joint venture with a Chinese company and restrict their equity ownership to a minority share in order to invest in the Chinese market.

Beginning in 2004 and continuing through 2005, the government employed a series of restrictive measures to cool what it considered an overheating economy. Some of these measures attempted to restrict further domestic and foreign investment in certain sectors, like real estate and steel. In the case of steel, the new measure – China's July 2005 steel policy – treats foreign investors more strictly. In particular, the new steel policy restricts foreign investment in a number of ways. For example, it requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. Given that foreign investors are not allowed to have a controlling share in steel and iron enterprises in China, this requirement would seem to constitute a *de facto* technology transfer requirement, in conflict with the commitment in China's accession agreement not to condition investment on the transfer of technology. This policy is also troubling because it attempts to dictate industry outcomes and involves the government making decisions that should be made by the market. The policy also prescribes the number and size of steel producers in China, where they will be located, the types of products that will and will not be produced, and the technology that will be used.

This high degree of government direction and decision-making regarding the allocation of resources into and out of China's steel industry is not only inconsistent with the spirit of China's obligations as a member of the WTO, but raises concerns specifically because of the commitment that China made in its WTO accession agreement that the government would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises.

China also prohibits foreign investment in certain sectors. Citing national security interests, China bans foreign investment in news agencies, radio and TV broadcasting stations and networks, radio and TV programming, film production and screening, and the publication, importation and wholesale distribution of press and audio-visual products. The production of arms by foreign investors is also prohibited, as is the mining and processing of certain minerals. U.S. investors have expressed particular concern about China's prohibition of investment in the production and development of plant seeds that are a product of biotechnology.

Other Investment Issues

Venture Capital

Regulations that took effect in March 2003 replaced earlier regulations permitting the establishment of foreign-invested venture capital firms, including wholly foreign-owned enterprises, aimed at funding high-technology and new technology startups in industries open to foreign investment. The March 2003 regulations lower capital requirements, allow these firms to manage funds directly invested from overseas, and offer the option of establishing venture capital firms under an organizational form similar to the limited liability partnerships used in other countries.

Meanwhile, regulations that took effect in April 2001 permit foreign private equity firms subject to limits on corporate structure, share issuance and transfers, and investment exit options. These same regulations, however, bar all domestic and foreign securities firms from the private equity business.

Investment exit problems, especially the difficulty of listing on China's stock exchanges, coupled with the bureaucratic approvals required to list overseas, have limited interest in establishing China-based venture capital and private equity investment. As a result, most foreign venture capital and private equity investments in China are actually housed in offshore investment entities, which, as with other offshore FDI, can be transferred without Chinese government approval.

The Chinese government issued new regulations for domestic venture capital firms in the fall of 2005, and implementing rules are expected to be issued in 2006. It is unclear if these measures will allow foreign firms choosing to operate onshore to take advantage of the incentives offered to domestic firms.

Holding Companies

There has been some relaxation of restrictions on the scope and operations of holding companies, although minimum capital requirements normally make them suitable only for corporations with several sizeable investments to manage. Holding companies may manage human resources across their affiliates and also provide certain market research and other services. However, some restrictions on services provided by holding companies and on holding companies' financial operations and ability to balance foreign exchange internally will remain even after full implementation of China's WTO commitments. Profit and loss consolidation within holding companies also remains prohibited.

Access to Capital Markets

Foreign-invested enterprises in China remain largely unable to access domestic and international stock markets, to sell corporate bonds, to accept venture capital investment, to sell equity, or to engage in normal merger, acquisition and divestment activity. Foreign exchange transactions on the capital account can be concluded only with case-by-case official review, and approvals are subject to very tight regulatory control. These barriers to capital market access were not addressed by China's WTO accession agreement.

China has begun to experiment with liberalization, such as the opening of domestic stock markets to listings by foreign-invested firms. Through the Qualified Foreign Institutional Investor (QFII) program, foreign securities firms can gain limited access to the RMB-denominated A share market by applying for QFII status with the Chinese government. As of December 2005, 32 foreign firms had been granted QFII status, and 31 of them had been issued QFII investment quotas totaling $5.645 billion.

GOVERNMENT PROCUREMENT

In accordance with the terms of its WTO accession agreement, China agreed to conduct its government procurement in a transparent manner and to provide all foreign suppliers with equal opportunity to participate in procurements opened to foreign suppliers. China also committed to become an observer to the WTO Agreement on Government Procurement (GPA), which it did in May 2002, and to table an offer and initiate negotiations for membership in the GPA "as soon as possible." In the interim, China agreed that all of its central and local government entities would conduct their procurements in a transparent manner, as reflected in its WTO accession agreement. China also agreed that, if procurement were opened to foreign suppliers, it would provide MFN treatment by allowing all foreign suppliers an equal opportunity to participate in the bidding process.

While China has still not initiated GPA negotiations, it did promulgate its first Government Procurement Law in July 2002. In part, this was a response to the need to separate purchases by "state-owned enterprises," which China had agreed in its WTO accession agreement would be made on a commercial basis, from "government procurement." China also agreed that the government would not influence the commercial decisions of state-owned enterprises, although in practice this has not consistently been the case.

The Government Procurement Law, which became effective on January 1, 2003, attempts to follow the spirit of the GPA and incorporates provisions from the United Nations Model Law on Procurement of Goods. However, the law also directs central and sub-central government entities to give priority to "local" goods and services, with limited exceptions. China envisions that this law will improve transparency, reduce corruption and lower government costs. The law is also seen as a necessary step toward reforming China's government procurement system in preparation for China eventually becoming a Party to the GPA. In August 2004, MOF issued implementing rules stipulating that procurement of foreign goods, works and services, which are allowed in exceptional circumstances, are subject to review and approval by MOF.

MOF also issued measures in August 2004 covering bidding procedures, publication of information and the handling of complaints related to government procurements. The rules on bidding procedures require all government procurements over a certain amount to be conducted through public bidding. According to the 2004 catalogue for central-government financed government procurement, the threshold for public bidding is RMB 1.2 million ($144,000). To be eligible to participate, suppliers must be domestic and provide "domestic goods and services." MOF is reportedly formulating the criteria for "domestic goods and services." The rules on publication of information require procuring entities and their agencies to make public all necessary information through media outlets designated by MOF. These rules define this information as statutes, data and other materials concerning government procurements, and also require the disclosure of detailed information concerning bid invitations and bidding. The rules on the handling of complaints require MOF and local finance administrations to respond to complaints from suppliers regarding the conduct of procurements. Suppliers may apply for administrative review of a ruling or file an administrative suit in court.

Meanwhile, beginning in 2003, U.S. companies expressed concerns about implementing rules on government software procurement being drafted by MOF. At a time when China's already large software market was projected to grow by more than 50 percent annually, the initial draft of these rules reportedly contained guidelines mandating that central and local governments – the largest purchasers of software in China – purchase only software developed in China to the extent possible. In October 2004, MOF issued a notice seeking input from foreign enterprises regarding the software procurement rules being drafted. Although no actual draft of those rules was included, it appeared that MOF was taking a very restrictive approach in defining "domestic products." The United States and U.S. industry were concerned not only about U.S. software exporters' continuing access to China's large and growing market for packaged and custom software – $7.5 billion in 2004 – but also about the precedent that could be established for other sectors if China proceeded with MOF's proposed restrictions on the purchase of foreign software by central and local governments. At the July 2005 JCCT meeting, China took note of the United States' strong concerns and indicated that it would indefinitely suspend the drafting of implementing rules on government software procurement.

Finally, at the July 2005 JCCT meeting, China agreed to commence "technical discussions" with the United States and other WTO members in preparation for the initiation of negotiations to join the GPA. The first round of technical discussions between China and the United States was scheduled to take place in February 2006.

ELECTRONIC COMMERCE

China has experienced dramatic growth in Internet usage since 1999. According to the 16th Internet survey recently published by the China Internet Network Information Center (CNNIC) in July 2005, the number of people in China with access to the Internet was approximately 103 million, an increase of 10 percent year on year, second only to the United States in terms of total users. Falling personal computer prices and the arrival of devices tailored for the Chinese market will further expand Internet access.

China has also experienced a dramatic increase in the number of electronic businesses established. An estimated 78 percent of all Chinese websites are now operated by "enterprises" and 5 percent by "businesses." By the end of June 2005, there were roughly 677,500 registered websites in China. Of this total, there were 622,534 domain names registered under ".cn". However, despite these developments, only 11 percent of Chinese "enterprise" websites and 45 percent of Chinese "business" websites offer "e-commerce services." Nevertheless, China is experiencing rapid development of on-line business such as search engines, network education, on-line advertisements, audio-video service, paid e-mail, short message, on-line job hunting, Internet consulting and on-line gaming.

The Chinese government recognizes the potential of electronic commerce to promote exports and increase competitiveness and has made some progress toward establishing a viable commercial environment. However, some Chinese ministries with responsibility for electronic commerce have excessively regulated the Internet, thereby stifling the free flow of information and the consumer privacy needed for electronic commerce to flourish. Content is still controlled and encryption regulated, as discussed more fully above (in the "Online Services" section).

A number of technical problems also inhibit the growth of electronic commerce in China. Rates charged by government-approved Internet service providers make Internet access expensive for most Chinese citizens. Slow connection speeds are another problem, although this is changing as broadband connections become more readily available. In 2005, nearly 53 percent of China's Internet users had broadband connections, representing an increase of 15 percent over 2004, and China Telecom is now reportedly the world's largest DSL operator. There are now more than 30 million broadband subscribers in China. China surpassed Japan in 2004 as the country with the second most broadband lines after the United States. At the same time, Internet penetration remains relatively low in China, so there is still significant room for growth.

Other impediments to Chinese businesses and consumers conducting online transactions include the paucity of credit payment systems, consumer reluctance to trust online merchants, the lack of secure online payment systems and inefficient delivery systems. China has also yet to develop a legal framework conducive to the rapid growth of electronic commerce. Laws recognizing the validity of "e-contracting" tools and stressing the importance of online privacy and security have been proposed, but not yet issued. Despite these obstacles, however, a large and growing percentage of Chinese Internet users reportedly have made online purchases.

In a positive development, China passed E-signature legislation in August 2004, which became effective on April 1, 2005. China is also in the process of drafting data privacy legislation.

ANTICOMPETITIVE PRACTICES

China continues to struggle with economic inefficiencies and investment disincentives created by local protectionism, pricing practices and preservation of industry-wide monopolies. Anticompetitive practices in China take several forms. In some cases, industrial conglomerates operating as monopolies, near monopolies or authorized oligopolies (as in the telecommunications industry) may have been allowed to fix prices, allocate contracts and in other ways restrict competition among domestic and foreign suppliers. In addition, regional protectionism by provincial or local authorities often blocks efficient distribution of goods and services inside China. These practices may restrict market access for certain imported products, raise production costs and restrict market opportunities for foreign-invested enterprises in China. There are several existing laws and regulations in China addressing competition matters. However, these measures are largely ineffective due to poor national coordination and inconsistent local and provincial enforcement. China is drafting a new anti-monopoly law that could be adopted by late 2006.

Since November 2002, regulations have allowed foreigners to purchase traded and non-traded (or designated state) shares of Chinese enterprises. In addition, regulations that took effect in April 2003 specify procedures for foreign acquisition of and merger with domestic enterprises. These regulations require pre-merger notification and allow for examination of antitrust considerations in some cases. By requiring approval of all owners of the Chinese enterprise, the regulations implicitly prohibit hostile takeovers. The thresholds for notification are also not straightforward, leaving open the possibility of abuse by officials or domestic competitors. Domestic competitors have the power under the regulations to call for public hearings on prospective mergers.

China also issued regulations in November 2002 addressing the use of foreign investment to reorganize state-owned enterprises. These reorganizations, however, require extensive approvals and the agreement of the state-owned enterprise's labor union. These requirements have limited the appeal of this type of investment.

OTHER BARRIERS

Transparency

In its WTO accession agreement, China committed to publish all laws, regulations and other measures that relate to trade matters, including those that affect imports, and generally to provide a reasonable period for commenting on them before implementation. China also agreed to establish or designate an official journal for the publication of these trade-related measures. In addition, China agreed to provide a copy of new trade-related laws, regulations and other measures to the WTO Secretariat in Geneva, translated into one or more of the WTO's official languages (English, French and Spanish) no later than 90 days after implementation. China further agreed to create various enquiry points for its WTO trading partners and foreign businesses to obtain information about these measures.

Various government-owned specialty newspapers routinely carry the texts of government regulations, implementing rules, circulars and announcements. Many government ministries also publish digests or gazettes containing the texts of these measures, both in written form and on their websites. In addition, there has been a proliferation of online news and information services that routinely offer up-to-date news about and texts of new laws and regulations. Some services even provide legal-quality English translations by subscription. However, many measures that do not rise to the level of ministry-issued regulations or implementing rules continue to remain unavailable to the public. China's ministries routinely implement policies based on internal "guidance" or "opinions" that are not available to foreign firms. Experimental or informal policies and draft regulations, in addition, are regarded as internal matters and public access is tightly controlled.

While positive in some respects, the sheer number of outlets through which trade-related measures are published complicates the ability of interested parties to track their development and issuance. In late 2002, China designated the China Foreign Economic and Trade Gazette as the official journal for this purpose. Published by MOFCOM and replacing the MOFCOM Gazette, it came out on a trial basis in October 2002 and as an official publication in January 2003. However, this journal does not carry draft measures for public comment, nor does it consistently carry trade-related measures developed by ministries and agencies other than MOFCOM. The establishment or designation of a single comprehensive journal would enhance the ability of WTO members to track the drafting, issuance and implementation of trade-related measures. Furthermore, the use of a single journal to request comments on proposed trade-related measures, as envisioned in China's WTO accession agreement, would facilitate the timely notification of comment periods and submission of comments.

In December 2001, the State Council issued regulations explicitly allowing comment periods and hearings. However, many of China's ministries and agencies continued to follow the practice prior to China's accession to the WTO. The ministry or agency drafting a new or revised law or regulation will normally consult with and submit drafts to other ministries and agencies, Chinese experts and affected Chinese companies. At times, it will also consult with select foreign companies, although it will not necessarily share drafts with them. As a result, only a small proportion of new or revised laws and regulations have been issued after a period for public comment, and even in these cases the amount of time provided for public comment has generally been short.

In 2004, some improvements took place, particularly on the part of MOFCOM, which began following the rules set forth in its *Provisional Regulations on Administrative Transparency*, issued in November 2003. Those rules could potentially serve as a model for other ministries and agencies seeking to improve their transparency. Nevertheless, basic compliance with China's notice-and-comment commitment continued to be uneven, both in 2004 and 2005. For example, China did not provide for public comment on major trade-related laws and regulations, such as the April 2005 *Measures on the Importation of Parts for Entire Automobiles*. In the area of intellectual property rights, however, a number of ministries and agencies circulated proposed measures for public comment in 2005.

Meanwhile, China's ministries and agencies continue to have a much better record when it comes to making new or revised laws and regulations available to the public. In accordance with State Council regulations issued in December 2001, which require the publication of new or amended regulations thirty days before their implementation, almost all new or revised laws and regulations have been available (in Chinese) soon after issuance and prior to their effective date, an improvement over pre-WTO accession practice. Indeed, these laws and regulations are often published not only in official journals, but also on the Internet. At the same time, however, China continues to lag behind in its obligation to provide translations of these laws and regulations.

U.S. industry continues to report instances where Chinese companies are provided unofficial guidance by Chinese regulators, guidance which is usually unavailable to foreign entities. In some cases, Chinese officials provided unpublished documents to interested parties, but this dissemination was ad hoc and based more on personal connections than formal procedures.

MOFCOM's predecessor, MOFTEC, in late 2001, established an enquiry point to provide information on new trade and investment laws, regulations and other measures. Other ministries and agencies have also established formal or informal, subject-specific enquiry points. Since the creation of these various enquiry points, U.S. companies have generally found them to be responsive and helpful, and have generally received timely replies.

Legal Framework

Laws and Regulations

Laws and regulations in China tend to be more general and ambiguous than in other countries. While this approach allows the Chinese authorities to apply laws and regulations flexibly, it also results in inconsistency and confusion in application. Companies often have difficulty determining whether their activities contravene a particular law or regulation.

In China, regulations are also promulgated by a host of different ministries and governments at the central, provincial and local levels, and it is not unusual for the resulting regulations to be at odds with each other. Even though finalized regulations are now routinely published in China, they often leave room for discretionary application and inconsistencies, either through honest misunderstanding or by design. Indeed, government bureaucracies have sometimes been accused of selectively applying regulations. China has many strict rules that are often ignored in practice until a person or entity falls out of official favor. Governmental authorities can wield their discretionary power to crack down on foreign or disfavored investors or make special demands on them simply by threatening to crack down.

This lack of a clear and consistent framework of laws and regulations can be a barrier to the participation of foreign firms in the Chinese domestic market. A comprehensive legal framework, coupled with adequate prior notice of proposed changes to laws and regulations, and an opportunity to comment on those changes, would greatly enhance business conditions, promote commerce and reduce opportunities for corruption. The U.S. Government has provided technical assistance, at the central and local levels of government in China, in an effort to

promote improvements in China's legislative and regulatory drafting process. In its WTO accession agreement, China committed to establish tribunals for the review of all administrative actions relating to the implementation of trade-related laws, regulations, judicial decisions and administrative rulings. These tribunals must be impartial and independent of the government authorities entrusted with the administrative enforcement in question, and their review procedures must include the right of appeal. To date, little information is publicly available regarding the frequency or outcomes of review before these tribunals.

China also committed, at all levels of government, to apply, implement and administer all of its laws, regulations and other measures relating to trade in goods and services in a uniform and impartial manner throughout China, including in special economic areas. In connection with this commitment, in 2002, China also established an internal review mechanism, now overseen by MOFCOM's Department of WTO Affairs, to handle cases of non-uniform application of laws. The actual workings of this mechanism remain unclear, however.

Commercial Dispute Resolution

Both foreign and domestic companies often avoid seeking resolution of commercial disputes through the Chinese courts, as skepticism about the independence and professionalism of China's court system and the enforceability of court judgments and awards remains high. There is a widespread perception that judges, particularly outside of China's big cities, are subject to influence by local political or business pressures. Most judges are not trained in the law and/or lack higher education, although this problem decreases at the higher levels of the judiciary.

At the same time, the Chinese government is moving to establish consistent and reliable mechanisms for dispute resolution through the adoption of improved codes of ethics for judges and lawyers and increased emphasis on the consistent and predictable application of laws. The Judges' Law, issued by the Standing Committee of the National People's Congress in 1995, requires judges to have degrees in law or in other subjects where they have acquired specialized legal knowledge, and permits judges appointed before the law's implementation who do not meet these standards to undergo necessary training. In 1999, the Supreme People's Court began requiring judges to be appointed based on merit and educational background and experience, rather than through politics or favoritism. In 2002, the Supreme People's Court issued rules designating certain higher-level courts to hear cases involving administrative agency decisions relating to international trade in goods or services or intellectual property rights. According to the Supreme People's Court, China's more experienced judges sit on the designated courts, and the geographic area under the jurisdiction of each of these designated courts has been broadened in an attempt to minimize local protectionism. The rules provide that foreign or Chinese enterprises and individuals may bring lawsuits in the designated courts raising challenges, under the Administrative Litigation Law, to decisions made by China's administrative agencies relating to international trade matters. The rules also state that when there is more than one reasonable interpretation of a law or regulation, the courts should choose an interpretation that is consistent with the provisions of international agreements to which China has committed, such as the WTO rules.

Despite initial enthusiasm, foreign observers have grown increasingly skeptical of the China International Economic and Trade Arbitration Commission (CIETAC) as a forum for the arbitration of trade disputes. Some foreign firms have obtained satisfactory rulings from CIETAC but other firms and legal professionals have raised concerns about restrictions on the selection of arbitrators and inadequacies in procedural rules necessary to ensure thorough, orderly and fair management of cases.

Finally, in cases where the judiciary or arbitration panels have issued judgments in favor of foreign-invested enterprises, enforcement of the judgments has often been difficult. Officials responsible for enforcement are often beholden to local interests and unwilling to enforce court judgments against locally powerful companies or individuals.

Labor Issues

In recent years, China has expanded the scope of its national labor laws and regulations so they now cover most, though not all, key labor areas. Even with these changes, China does not adhere to certain internationally recognized labor standards, such as the rights of freedom of association and collective bargaining. In addition, critics allege that China's household registration system is equivalent to a form of forced or compulsory labor, and there are many reports indicating that China does not enforce its laws and regulations concerning minimum wages, hours of work and occupational safety and health. There are also persistent concerns about the use of prison labor and child labor.

The Chinese government is slowly developing nationwide pension, unemployment insurance, medical insurance and workplace injury insurance systems that require substantial employer contributions. These systems are still rudimentary and characterized by serious funding shortfalls, in part due to widespread non-compliance among domestic firms. There is also inconsistent application and enforcement of labor regulations between Chinese-owned enterprises and foreign-invested enterprises.

The cost of labor, especially unskilled labor, is low in much of China. The existence of a large pool of surplus rural workers, many of whom seek work in urban areas, helps to keep unskilled wages low. Some companies offering substandard wages and working conditions have experienced shortages of unskilled labor. Where competition for workers is intense and the supply limited, as in the case of technical, managerial and professional staff in China's coastal areas, wages can be higher. However, restrictions on labor mobility distort labor costs. China is gradually easing restrictions under the country's household registration system, which has traditionally limited the movement of workers within the country, in part due to the recognition that labor mobility is essential to the continued growth of the economy.

In 2005, the China National Textile and Apparel Council established the Committee for the Promotion of Corporate Social Accountability System for Chinese Textile Enterprises (CSC9000T). Reportedly, increasing numbers of Chinese firms have realized the importance of social accountability, but remain confused about the various foreign corporate social accountability standards and certifications bodies that exist. The council

formed CSC9000T to formulate Chinese corporate social responsibility standards to promote among Chinese firms. The standards are based on relevant Chinese legislation and regulations and reference international practices. To date, 160 council members have adopted these standards. This year, the committee will focus its efforts on promoting the adoption of these standards, conducting surveys on standards implementation, increasing communication with international buyers and providing training opportunities.

Corruption

Many people expected that China's entry into the WTO, which mandated a significant reduction in tariffs, would in turn reduce incentives for smuggling-related corruption. While WTO membership has increased China's exposure to international best practices and resulted in some overall improvements in transparency, corruption remains endemic. Chinese officials themselves admit that corruption is one of the most serious problems the country faces, and China's new leadership has called for an acceleration of the country's anti-corruption drive with a focus on closer monitoring of provincial-level officials. According to the most recently available information from Chinese state media sources, in 2004, Chinese prosecutors caught more than 42,000 officials for corruption and other offenses, reflecting a rise of one percent from 2003. Official graft was a leading offense, with prosecutors recovering a total of RMB 3.8 billion ($456 million) of misappropriated and embezzled funds.

In July 2004, China implemented a new *Administrative Licensing Law*. This law is designed to increase transparency in the licensing process, an area that has long served as a source of official corruption. This law seeks to ensure the reasonable use of administrative licensing powers, to protect the interests of corporations and individuals, and to promote efficient administrative management by requiring government agencies to set up special offices for issuing licenses and to respond to applications within 20 days. It is too early to judge the effectiveness of this law. While some reports suggest that it has resulted in the removal of many unnecessary administrative licensing requirements, some agencies have been reluctant to implement the law and have continued to administer their licensing powers in ways that appear to conflict with the requirements of the law.

China issued its first law on unfair competition in 1993, and the central government continues to call for improved self-discipline and anti-corruption initiatives at all levels of government. While the central government in recent years has pledged to begin awarding contracts solely on the basis of commercial criteria, it is unclear how quickly and to what extent the government will be able to follow through on this commitment. U.S. suppliers complain that the widespread existence of unfair bidding practices in China puts them at a competitive disadvantage. This dilemma is less severe in sectors where the United States holds clear technological or cost advantages. Corruption nevertheless undermines the long-term competitiveness of both foreign and domestic entities in the Chinese market.

Land Issues

China's constitution specifies that all land is owned in common by all the people. In practice, agricultural collectives, under the firm control of local Communist Party chairmen, distribute agricultural land to the rural poor, while city governments distribute land for residential and industrial use. The State and collectives can either "grant" or "allocate" land use rights to enterprises in return for payment of fees. Enterprises granted land-use rights are guaranteed compensation if the State asserts eminent domain over the land, while those with allocated rights are not. Granted land-use rights cost more, not surprisingly, than allocated rights. However, the law does not define standards for compensation when eminent domain supercedes granted land-use rights. This situation creates considerable uncertainty when foreign investors are ordered to vacate. The absence of public hearings on planned public projects, moreover, can give affected parties, including foreign investors, little advance warning.

The time limit for land-use rights acquired by foreign investors for both industrial and commercial enterprises is 50 years. A major problem for foreign investors is the array of regulations that govern their ability to acquire land-use rights. Local implementation of these regulations may vary from central government standards, and prohibited practices may occur in one area while they are enforced in another. Most wholly-owned foreign enterprises seek granted land-use rights to state-owned urban land as the most reliable protection for their operations. Chinese-foreign joint ventures usually attempt to acquire granted land-use rights through lease or contribution arrangements with the local partners.

China's current rural land law, which took effect in 2003, gives peasants fixed contracts for periods of 30 to 50 years, and permits peasants to exchange or rent out their land-use rights while their use contract remains in force. There is no immediate prospect for changing from land-use rights to direct ownership of rural land. However, since 2004, the leadership has pressed for sturdier land rights for farmers along with stricter controls over the legal process for converting farmland from agricultural to industrial or residential use. Local governments are no longer supposed to expropriate land for commercial use, as farmers are now supposed to be able to negotiate a compensation price for land directly with commercial users. However, implementation of these provisions lags.