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MEMORANDUM FOR: David M. Spooner
Assistant Secretary
for Import Administration

THROUGH: Joseph A. Spetrini
Deputy Assistant Secretary
for AD/CVD Policy and Negotiations

Ronald K. Lorentzen
Director, Office of Policy

Albert Hsu
Senior Economist

FROM: Shauna Lee-Alaia
Lawrence Norton
Anthony Hill
Office of Policy, Import Administration

DATE: August 30, 2006

SUBJECT: Antidumping Duty Investigation of Certain Lined Paper Products from the People's Republic of China ("China")- China's status as a non-market economy ("NME")

EXECUTIVE SUMMARY

In the antidumping duty investigation of certain lined paper ("lined paper") from China, the Department received a request from respondent, supported by the People's Republic of China government ("PRC government"), to conduct a review of China's NME status under the U.S. antidumping law. The Department issued a memorandum on May 15th, 2006 (the "May 15th memorandum"), determining that China shall remain an NME for purposes of the U.S. antidumping law. In the May 15th memorandum, the Department focused mainly on deep-rooted distortions in China's banking sector, noting that the state of the banking sector, along with broader economy-wide distortions, demonstrate that China's economy has not yet attained market-economy status for purposes of the U.S. antidumping law. The Department stated further that it would issue at a later stage of the lined paper investigation a comprehensive analysis of all six statutory factors that govern NME country designation. Accordingly, this memorandum provides the Department's full analysis underlying the May 15th decision.

The Department has treated China as an NME country in all past antidumping duty investigations and administrative reviews. A non-market economy for purposes of the U.S. antidumping law is defined in section 771(18)(A) of the Tariff Act of 1930 (the "Act") as "any country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." The Department's designation of a country as an NME applies only to U.S. trade remedy proceedings. In making an NME country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department examine an economy as a whole, as opposed to individual industries or companies, and take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;
3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and,
6. such other factors as the administering authority considers appropriate.

With regard to factor one, the Department notes that the *renminbi* is convertible into foreign currencies for trade purposes, but that China still maintains significant restrictions on both the interbank foreign exchange ("FOREX") market and on capital account transactions. It appears that these restrictions interfere with the ability of market signals to impact the exchange rate. At the same time, the Department notes that China has implemented important reforms to its currency regime in recent years and is developing its FOREX market. Although significant capital account controls remain in place, the PRC government has made initial moves to liberalize both inward and outward capital flows. Therefore, while China's reforms to date cannot ensure that the *renminbi* is market-based, neither is the currency completely insulated from market forces.

In its analysis of factor two, the Department finds that wages between employers and employees appear to be largely negotiated, as opposed to government-set, as evidenced by the variability in wages across regions, sectors, and enterprises. While the Department does not undertake an analysis of all potential worker rights, we note that workers have certain rights with respect to compensation and choice of employment. There are a number of important institutional and administrative constraints, including the lack of independent unions, prohibition on the right to strike, as well as significant restrictions on labor mobility, which limit the extent to which market forces influence the formation of wages. However, employers, while hampered in the ability to reduce staff, are generally free to make independent decisions regarding labor.

Under factor three, the Department notes that China permits all forms of foreign investment, *e.g.*, joint ventures and wholly-owned companies, in most sectors of the economy. Foreign investors are free to repatriate profits and investments are protected from nationalization and expropriation. However, despite being open to foreign investment, as shown by the large flows of foreign direct investment ("FDI") over the past decade, China still manages foreign investment to significant degree, *e.g*., by guiding FDI towards favored export-oriented industries and specific regions, shielding certain domestic firms from competition, and relying on industry-specific FDI rules and regulations.

As concerns factor four, China has made progress in privatizing state-owned enterprises ("SOEs") and introducing limited market practices to state-owned firms. However, while the PRC government has made a decision to recede from direct state control over certain parts of the economy, it also intends to maintain and bolster state control in other areas, especially in the "core" or "pillar" industries. Further, private land ownership is prohibited in China, even though land-use rights can be held by individuals and firms. While the private market for land-use rights has grown, SOEs retain a significant amount of land-use rights that they received free of charge and commercial land-use rights are obtained illegally. In short, property rights remain poorly defined and weakly enforced.

With regard to factor five, *i.e.*, the government's control over the allocation of resources, the Department notes that the era of China's command economy has receded and the majority of prices are liberalized. There is also evidence of some market-based resource allocations. The state-owned sector is shrinking in relative terms, with redundant labor being absorbed by other sectors. A limited number of SOEs are profitable and competitive. The growing private sector is productive, profitable, and increasingly driving economic growth. Bank lending to the private sector has increased at the margin, growing from nearly zero credit.

Nevertheless, the PRC government, at all levels, remains deeply entrenched in resource allocation. Importantly, as noted in the May 15th memorandum, the various levels of government in China, collectively, have not withdrawn from the role of resource allocator in the financial sector. As a general rule, investment funds do not flow to their best use at the firm, industry or sector level. Moreover, the underperforming SOE sector still accounts for a disproportionate share of bank lending, fixed asset investment and other resources allocations.

Finally, the Department notes under factor six that China faces a myriad of major challenges in overcoming institutional weaknesses regarding rule of law, property rights and bankruptcy.

The Department recognizes the important positive changes, both *de jure* and *de facto*, that China's economy has experienced in the past 25 years. The PRC government has undertaken significant reforms to promote the introduction of markets forces into the economy. However, in applying the factors required under section 771(18)(B) of the Act, we recognize that

China has a dynamic (but constrained) private sector, but also find that the state retains for itself considerable levers of control over the economy.

In conducting its analysis of China's status as an NME for purposes of the U.S. antidumping law, the Department has considered the totality of China's economic reforms. While China has enacted significant and sustained economic reforms, our conclusion, as stated in the May 15th memorandum, is that market forces in China are not yet sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's dumping analysis. The Department shall, therefore, continue to treat China as an NME for purposes of the U.S. antidumping law.

INTRODUCTION

In the antidumping duty investigation of certain lined paper from China, the Department received a request from respondent, supported by the PRC government, to conduct a review of China's NME status under the U.S. antidumping law. The Department issued a memorandum to the file on May 15th, 2006, determining that China shall remain an NME for purposes of the U.S. antidumping law. In the May 15th memorandum, the Department focused mainly on deep-rooted distortions in China's banking sector, noting that the state of the banking sector, along with broader economy-wide distortions, demonstrate that China's economy has not yet attained market-economy status. The Department stated further that it would issue at a later stage of the lined paper investigation a comprehensive analysis of all six statutory factors that govern NME country designation. Accordingly, this memorandum provides the full analysis underlying the May 15th decision. The Department's designation of China as an NME applies only in U.S. trade remedy proceedings and is guided by the statutory factors described below.

The Department recognizes that the PRC government has taken significant steps to integrate China into the world economy. China's economy has registered impressive and sustained economic growth for over two decades. The PRC government no longer sets most prices in the economy and has allowed the private sector to develop in many areas. China attracts significant flows of foreign direct investment, aiding the growth of the private sector. However, the level of government intervention in the economy is still so significant that prices and costs cannot be relied upon to constitute meaningful measures of value. China's currency, the *renminbi*, remains insulated from market forces, even though it is convertible on the current account and despite recent reform efforts. With regard to wages, we note that a number of important institutional and administrative constraints – including the lack of independent unions, prohibition on the right to strike, as well as significant restrictions on labor mobility – limit the extent to which market forces influence the formation of wages. The state is committed to maintaining a significant role in production and the allocation of resources in the economy, as evidenced by its policy to preserve state ownership of key industrial sectors.

Moreover, firms in industries that are dominated by the private sector also operate in a distorted business environment, as various levels of government and largely unreformed institutions influence the actions of private actors through powerful controls and incentives. The banking sector remains virtually wholly state-owned, and despite recent reforms, continues to issue credit on a non-commercial basis. Finally, private land ownership is neither allowed nor envisioned and, more generally, private property rights are not adequately formulated or protected. This suggests that while the private sector is more active than in traditional command economies, the state still reserves for itself considerable levers of control over the economy and its direction.

In conducting its analysis, the Department has considered the totality of China's economic reforms. While China has enacted significant and sustained economic reforms, our conclusion, as stated in the May 15th memorandum, is that market forces in China are not yet sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's dumping analysis. China shall, therefore, remain an NME for purposes of the U.S. antidumping law.

BACKGROUND

On December 22, 2005, counsel on behalf of respondents Watanabe Paper Product (Shanghai) Co., Ltd., Hotrock Stationary (Shenzhen) Co., Ltd., and Watanabe Paper Product (Linqing) Co., Ltd. (collectively, the "Watanabe Group") submitted a request that the Department reevaluate China's status as an NME country under the U.S. antidumping law. On February 2, 2006, the Department received a submission from the Ministry of Commerce ("MOFCOM") expressing support for the Watanabe Group's request.

The Department has treated China as an NME country in all past antidumping duty investigations and administrative reviews. *See, e.g.*, Notice of Final Determination of Sales at Less Than Fair Value and Final Partial Affirmative Determination of Critical Circumstances: Diamond Sawblades and Parts Thereof from the People's Republic of China, 71 FR 29303 (May 22, 2006); Notice of Final Determination of Sales at Less Than Fair Value: Certain Artist Canvas from the People's Republic of China 71 FR 16116 (March 30, 2006); and, Notice of Final Determination of Sales at Less Than Fair Value: Chlorinated Isocyanurates From the People's Republic of China , 70 FR 24502 (May 10, 2005). A designation as an NME country remains in effect until it is revoked by the Department. *See* section 771(18)(C)(I) of the Act.

The Department issued a memorandum to the file on May 15th, 2006 determining that the Department shall continue to treat China as an NME for purposes of the U.S. antidumping law. In the May 15th memorandum, the Department focused mainly on distortions in the banking sector. However, the Department also stated that it would issue its analysis concerning all six statutory factors that govern NME country designation for purposes of the U.S. antidumping law within the context of the lined paper investigation. Accordingly, the current memorandum provides the Department's full analysis underlying the May 15th decision to continue China's NME designation.

ANALYTICAL APPROACH

A non-market economy for purposes of the U.S. antidumping law is defined in section 771(18)(A) Act as "any country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." The Department's designation of a country as an NME applies only in U.S. trade remedy proceedings. In making an NME country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department examine an economy as a whole, as opposed to individual industries or companies, and take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;
3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and,
6. such other factors as the administering authority considers appropriate.

In evaluating the six factors listed above, the Department has recognized that the removal or withdrawal of state controls over the economy is not sufficient for revocation of NME status. Rather, the Department considers whether the facts, as applied to the statutory factors, demonstrate that the economy is generally operating under market principles. To this end, Congress has provided the above-listed factors, which the Department must evaluate to determine whether, in the judgment of the Department, market forces in the country are sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's antidumping analysis.

The reason for this analysis is that prices and costs are central to the Department's dumping analysis and calculation of normal value. Therefore, the prices and costs that the Department uses must be meaningful measures of value. NME prices cannot be relied upon as meaningful measures of value because they do not, as a general rule, reflect the relative scarcity of resources used in production. The problem with NMEs is not one of distorted prices, *per se*, since few, if any, market economy prices are perfect measures of value, free of all distortions (*e.g.,* taxes, subsidies, or other government regulatory measures). The problem, instead, is the price *generation* process (*i.e.,* the extent to which independent demand and supply elements individually and collectively make a market-based price system work).

The Department's evaluation of the statutory criteria does not require that countries be judged against a theoretical model of a perfectly competitive *laissez-faire* economy. Instead, the Department's determination is based on comparing the economic characteristics of the country in question with the general operational characteristics of market economies, recognizing that market economies around the world have many different forms and features. Although it is not necessary that the country fully meet every statutory factor relative to other market economies, the Department must determine that the factors, taken together, indicate that reforms have reached a threshold level such that the country can be considered to have a functioning market economy.

In arriving at its final conclusion in the May 15th memorandum, as well as in preparing this comprehensive analysis, the Department carefully considered the facts and arguments presented by all of the interested parties who made submissions during this proceeding. In addition, consistent with the Department's practice in addressing prior market economy determinations, the Department has relied upon the publically available evaluation of China's economy by expert third-party sources such as the World Bank, the International Monetary Fund ("IMF"), the Organization for Economic Cooperation and Development ("OECD"), the World Trade Organization ("WTO"), the Asian Development Bank ("ADB"), and the Economist Intelligence Unit.

OVERVIEW OF ECONOMIC AND LEGAL REFORMS

Following the establishment of the People's Republic of Chine in 1949, the new government moved to institute an autarchical command-and-control economy. The government collectivized agriculture and diverted resources away from rural areas in an effort to industrialize the economy. China's industrial development in this era largely followed Soviet lines, focusing on heavy industry. From the placement of factories to the goods produced and crops grown, planners directed nearly every aspect of China's economy. Private property was abolished for both rural and urban dwellers. The state and its institutions (such as the village communes and state-owned businesses) directed many aspects of people's lives, including their education, workplace, and home. By the late 1970s, almost all of China's gross domestic product ("GDP") was produced by either state-owned or collective enterprises.[1] In December of 1978, the PRC government implemented certain reforms, starting with the re-organization of agriculture. The government allowed communal farms to be dissolved and gave more freedom to individual farmers.[2] While planning for grain production was not abolished, farmers could keep and sell any surplus production over their state-mandated quota, generating a powerful impetus for individuals to increase production. Known as the "household responsibility system," this was China's first major experiment in combining state direction with market incentives. Meanwhile, in order to increase exports, China also established four special economic zones ("SEZs") during this round of reforms. In these zones, the rigid rules of the command economy were relaxed, attracting the China's first significant foreign investment.

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[1] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 5.

[2] *Ibid* ,p 1.

The immediate gains realized from the first round of reforms, such as increased agricultural productivity, led China to enact enterprise reforms in 1984. In this period, the PRC government focused on improving the productivity of SOEs through a contracting system that required SOE managers to meet certain performance targets.[3] China also began allowing enterprises to keep more of their own profits and to sell excess output.[4] While still state-owned and part of a planning system, enterprises granted this autonomy on the margin were encouraged to increase production and produce merchandise in demand. As some price controls were loosened and some government authority was decentralized, local authorities saw an opportunity to open businesses; this led to the development of rural enterprises known as township and village enterprises ("TVEs"). Because TVEs were owned by local governments, they were better able to respond to changing conditions and, crucially, to satisfy the pent-up demand of the rural population for consumer goods of all kinds.

In 1988, China passed a landmark law representing the government's first effort to separate state ownership of enterprises from their management. *The State-Owned Enterprise Law* nominally made SOEs operationally independent from the government and responsible for their own profits and losses.[5] The government also experimented with leasing small SOEs.

In 1992, reform efforts were re-energized and expanded to other parts of China because of positive results in southern China, especially in the SEZs.[6] China began to embrace private enterprise and introduced reforms granting it a recognized place in the economy. The 1990s also saw the closure or privatization of a large number of heavily indebted SOEs and TVEs that had become a fiscal burden on local governments. As the PRC government began to liberalize prices in the economy, more and more SOEs began to lose money.[7] The 1997 Asian financial crisis further dampened these firms' profitability, adding to the momentum for further reform of China's SOEs. In a policy that was known as "keep the large and let go of the small," the government bailed out and supported larger core SOEs, while divesting itself of smaller firms.[8]

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[3] Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), p 2.

[4] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 2.

[5] *Ibid*, p 45.

[6] *Id. See also* Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), p 3.

[7] *The Economist Intelligence Unit, Country Profiles, China*, March 2006, p 32.

[8] Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), p 3.

The result was a steep drop in SOE employment from 1998 to 2003.[9] This created new problems, however, as SOEs in China have traditionally provided numerous services to their workers and families, a system that has proved difficult to replace.

In recent years, China's reforms have turned to the financial sector, which have repeatedly run up massive stocks of non-performing loans ("NPLs") due to banks' lending to loss-making SOEs. Because so much of bank lending in China has been tantamount to *de facto* grants to favored enterprises, the PRC government has had to bail out the major banks through multi-billion dollar capital infusions on several occasions.

Today, reforms continue throughout China's economy and the private sector remains a vibrant sector of the economy. However, as discussed below, government influence and control continue to distort key sectors of China's economy, and key market-supporting institutions remain underdeveloped.

Factor One. The extent to which the currency of the foreign country is convertible into the currency of other countries.

A country's integration into world markets is dependent upon the convertibility of its currency, which is a prerequisite for a market-based exchange rate. The greater the extent of currency convertibility, for both trade and investment purposes, the greater the supply and demand forces linking domestic market prices in the country to world market prices, and the greater the extent to which the exchange rate is market-based, provided that those supply and demand forces can be brought to bear on the foreign exchange market. The stronger this linkage between domestic and world prices, the more market-based domestic prices tend to be.

The *renminbi* has served as the official currency of China since the establishment of the People's Republic of China. In 1994, the PRC government abolished foreign exchange certificates and unified China's exchange rate. The government fixed the currency tightly to the dollar, particularly after the Asian financial crisis. There was no market-based FOREX market, and the currency's convertibility on both the current and capital accounts was restricted. Over the next decade, the PRC government implemented gradual reforms to China's FOREX regime, beginning with the introduction of current account convertibility. The government has been gradually liberalizing capital account transactions as well, starting with selected long-term investments, and has been developing FOREX markets. These efforts are still ongoing.

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[9] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 79.

1. Legal framework

The People's Bank of China ("PBOC") was established in 1948 and operated for the next thirty-five years as a Soviet-style unibank combining both central and commercial banking functions. In 1983, the PBOC assumed the role of a central bank.[10] The 1995 *Law on the People's Bank of China* sets forth the current functions of the PBOC.[11] The PBOC is tasked to, *inter alia*, conduct monetary policy and, together with the State Administration of Foreign Exchange ("SAFE"), FOREX policy.[12] The law also establishes that the PBOC operates under the guidance of the State Council, and that it submit its major decisions to the State Council for approval.[13]

The *renminbi* has been the sole official currency of China since the PRC government unified its exchange rate regime in 1994.[14] The primary legal instruments governing currency regulation and foreign exchange are the *Rules of the People's Republic of China on Foreign Exchange Control* of 1996 ("FOREX Rules") and the *Administrative Regulations on Foreign Exchange Settlements, Sales, and Payments* of 1996 ("FOREX Regulations").[15]

2. Developments in the economy

China assumed IMF Article VIII obligations in 1996, making the *renminbi* convertible for current account purposes.[16] Domestic and foreign companies and individuals are free to acquire, hold and sell foreign exchange, and foreign companies are free to repatriate capital and

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[10] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 11-12.

[11] *China Law Digest: Banks and Banking* (New York and Beijing: Martindale-Hubble International Law Digest, 2005). *See also* Garcia-Herrero, Alicia, Gavila, Sergio, and Santabarbara, Daniel, *China's Banking Reform: An Assessment of Its Evolution and Possible Impact* (Madrid: Banco de Espana, 2005), p 16.

[12] Article 4 *et al*. grants basic control over the currency to the PBOC (subject to State Council approval). However, the PBOC delegates various powers over foreign exchange to SAFE. SAFE regulates the day to day currency transactions, while PBOC is generally responsible for conducting monetary policy.

[13] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 11-12. *China Law Digest: Banks and Banking* (New York and Beijing: Martindale-Hubble International Law Digest, 2005). The State Council is the highest organ of the PRC government, in effect, the Cabinet. *See The Economist Intelligence Unit, Country Profiles, China*, March 2006, p 9.

[14] *The Economist Intelligence Unit, Country Profile, China*, March 2006, p 53.

[15] *China Law Digest: Banks and Banking* (New York and Beijing: Martindale-Hubble International Law Digest, 2005).

[16] *China: 2005 Article IV Consultation–Staff Report* (Washington, DC: International Monetary Fund, November 2005), p 49-50.

remit profits. The PBOC, in conjunction with SAFE (to which it delegates certain powers), manages the exchange rate to preserve a *de facto* nominal peg to the U.S. dollar and a basket of other currencies, allowing only modest movements in the value of the currency.[17] Each day, the PBOC announces a benchmark exchange rate of the *renminbi* against the U.S. dollar, which is based on the weighted-average exchange rates that prevailed in the interbank foreign exchange market on the previous day. In theory, the PBOC allows for a daily movement of the U.S. dollar-*renminbi* exchange rate of up to 0.3 percent from its daily benchmark dollar-*renminbi* rate.[18] In practice, however, the PBOC and SAFE regularly intervene in the interbank FOREX market to limit this movement.[19] Nonetheless, the exchange rate is not completely insulated from market forces, as evidenced by the PBOC's adjustment of the currency peg in July 2005, when, in response to ever-larger capital flows, it raised the value of the *renminbi* by about 2.1 percent against the U.S. dollar. Since then, the renminbi has appreciated against the dollar by about another 1.66 percent.[20]

Until early 2006, all U.S. dollar-*renminbi* transactions on the interbank market had to be conducted through the PBOC, hindering the development of a competitive FOREX market.[21] Because banks were prohibited from determining independently the rate at which they could both buy and sell *renminbi* against the U.S. dollar, market actors could not directly convey the signals essential to the formation of a market-based exchange rate. Over the past year, however, the PRC government has allowed approved banks to act as "market markers" in the interbank spot market, meaning that they are permitted to both buy and sell *renminbi* at rates that are, at least in part, of their own choosing.[22] While the PRC government continues to intervene actively in the FOREX market, the fact that interbank participants can buy and sell more freely indicates that market forces, however attenuated, are beginning to have a limited effect on the value of the *renminbi*.

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[17] The IMF classifies China as maintaining a conventional pegged arrangement due to the *de facto* maintenance of a fixed exchange rate. *See Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005), p 225.

[18] *Id. See also The Economist Intelligence Unit, Country Commerce: China*, 2006, p 74.

[19] *The Economist Intelligence Unit, Viewswire, China Economy: Rising heat on the currency to cool the economy*, July 11, 2006.

[20] *The Economist Intelligence Unit, Viewswire, China Finance: China Bank Hints at New Renminbi Rise*, August 10, 2006.

[21] *Construction Bank, HSBC Okayed for Yuan Dealing,* Comtex News Network, January 3, 2006.

[22] *The Economist Intelligence Unit, Country Commerce: China*, 2006, p 74. *See also FOREX Rate Forming Mechanism Reformed,* Financial Times Information, January 4, 2006.

The convertibility of the *renminbi* on the capital account is limited. Like some other countries at a comparable stage of economic development, China imposes capital account restrictions, *i.e.*, measures restricting the freedom to move money in and out of the country for investment purposes, to prevent volatility in capital movements.[23] Particularly for a country with a fragile domestic financial sector potentially vulnerable to financial crises, such restrictions may be an appropriate response if the restrictions serve primarily to regulate, rather than fundamentally distort, the international flow of capital.

In the case of China, the PRC government imposed numerous restrictions in the wake of the Asian financial crisis. In recent years, however, it has begun to liberalize capital account transactions. Under the recently announced Qualified Domestic Institutional Investor Program ("QDII"), certain select domestic institutions will be permitted to invest a portion of their assets abroad. The latest data available suggests that six domestic Chinese banks are now permitted to invest U.S. $8.8 billion abroad.[24] While the details of this program have not yet been fully outlined, and while significant controls on capital outflows still exist, the QDII program nonetheless may represent a first step towards the liberalization of capital outflows.[25]

China's capital account restrictions serve not only to prevent the outflow of capital, but also limit capital inflows. Until recently, most foreign investors were prohibited from purchasing most domestic stocks and bonds, or were allowed only to buy separate stock reserved for foreigners.[26] Under China's Qualified Foreign Institutional Investor Program ("QFII"), however, select foreign investors are permitted to invest in domestic markets, although there are remaining restrictions on the remittance of capital and on owning majority stakes in domestic enterprises in China.[27] As of July 2006, more than 40 foreign institutions had permission to invest a total of more than U.S. $7 billion in China's securities markets.[28]

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[23] *See*, generally, *Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005).

[24] Poon, Terence, *China to Add More Banks to QDII Program*, Wall Street Journal, August 30, 2006.

[25] *China eases capital controls on overseas investment,* Agence France Presse, July 23, 2006. *See also QDII Licenses could be more lucrative as rules are eased,* South China Morning Post, July 25, 2006.

[26] *The Economist Intelligence Unit, Country Finance: China,* 2005, p 97-99.

[27] *Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005), p 230.

[28] *Morgan Stanley Gains Approvals to Trade on China Exchanges*, Dow Jones Newswires, July 11, 2006.

Assessment of Factor

The *renminbi* is convertible into foreign currencies for trade purposes. China still maintains significant restrictions on both the FOREX market and on capital account transactions. These restrictions may have been originally put into place to shield the currency from excess volatility, currency speculation, and to protect the domestic financial sector. In recent years, however, as evidenced by sustained macroeconomic imbalances, it appears that these restrictions continue to interfere with the ability of market forces to impact the exchange rate.

Nonetheless, China has implemented some market-oriented reforms to its currency regime in recent years and is developing its FOREX market. Market actors now have freedom to exercise limited influence on the value of the currency, and this has been reflected in small adjustments to the official exchange rate. Meanwhile, although significant capital account controls remain in place, the PRC government has made important initial moves to liberalize both inward and outward capital flows. While China's reforms to date do not ensure that the *renminbi* is truly market-based, neither is the currency completely insulated from market forces.

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

This factor focuses on the manner in which wages are set because they are an important component of a producer's costs and prices and, in turn, are an important indicator of a country's overall approach to setting prices and costs in the economy. The reference to "free bargaining between labor and management" reflects concerns about the extent to which wages are market-based, *i.e.*, about the existence of a market for labor services in which workers and employers are free to bargain over the terms and conditions of employment.

China has an enormous workforce of approximately 800 million workers, with 17 million new workers in 2006 alone.[29] Reduction in poverty, together with dealing with the layoffs associated with privatization, have been the driving forces behind much of China's efforts to reform labor policies. Similarly, China's labor policies and worker rights have attracted a great deal of attention from international labor rights advocates. A number of initiatives have focused on China's labor environment, both the legal structure that guides employment relations and worker and children rights, as well as workplace safety in China.[30] The Department's analysis of this statutory factor necessarily has a somewhat different focus and, therefore, cannot address fully within the context of this memorandum all intersections between worker rights and wage

[29] *NDRC Says China Faces Vast Troubling Labor Surplus*, China Daily, February 2006. Out of this workforce 49 percent are in the agricultural sector, 22 percent are in the industrial sector and 29 percent are in the service sector. *See China: Labor Force by Occupation* (Washington, DC: CIA World Fact Book, 2003).

[30] *See*, for example, the recent section 301 petition filed on June 8, 2006 by the American Federation of Labor and Congress of Industrial Organizations et al.

formation. Nevertheless, based on information from expert, third-party sources, the analysis below does touch upon some of these issues, especially to the extent that the abrogation of certain rights inhibit market forces from affecting wage formation, *i.e.,* "free bargaining between labor and management."

Prior to the reform era, China's labor force was entirely segmented, both by the household registration system as well as by government organization of labor through work units (*danwei*) in urban areas and communes in rural areas.[31] There were no sectoral or geographic labor flows.[32] Under the cradle-to-grave industrial employment system, completely devoid of market forces, employees were assigned to SOEs and guaranteed lifetime employment and social services. Wages were set by the government with no regard to the profitability of the enterprise. Reforms in the 1980s relaxed the lifetime employment requirement in SOEs, allowing for limited use of labor contracts.[33] In rural areas, the 1980s witnessed a boom in TVEs, which were granted significant autonomy and offered off-farm wages.[34] Regulations in the early 1990s abolished central planning for labor allocation as well as provided SOE management, for the first time, the legal right to make independent decisions about conditions and types of employment as well as the number of employees.[35] Responsibility for the delivery of social services and social welfare benefits began to shift slowly from SOEs to local governments.[36]

[31] *Income Disparities in China* (Paris: Organization for Economic Cooperation and Development, 2004), p 98.

[32] *China: Integration of National Product and Factor Markets* (Washington, DC: The World Bank, June 13, 2005), p 73.

[33] Labor contracts in SOEs were first introduced in 1986. Initially, only new employees were offered contracts. The requirement for contract-based employment became universal in 1996, at which time only 40 percent of employees held contracts. More systemic implementation was realized by 2000 . *See* Hu, Yifan, Opper, Sonja, and Wong, Sonia, *Political Economy of Labor Retrenchment: Evidence Based on China's State-Owned Enterprises* (The Journal of Economic Literature, July 2004), p 6.

[34] In the early 1980s, the government encouraged rural labor to "leave the land without leaving the village," *i.e.*, a movement from farming to TVEs. As TVEs encountered increasing competition through the following decade, they were forced to improve technologies through capital investment, as opposed to employing more labor; the growth in employment opportunities in TVEs subsequently slowed down. *See China Integration of National Product and Factor Markets* (Washington, DC: The World Bank, June 13, 2005), p 24.

[35] Hu, Yifan, Opper, Sonja, and Wong, Sonia, *Political Economy of Labor Retrenchment: Evidence Based on China's State-Owned Enterprises* (The Journal of Economic Literature, July 2004), p 7.

[36] Frenkel, Steven and Kuruvilla, Sarosh, *Logics of Action, Globalization, and Changing Employment Relations in China, India, Malaysia, and the Philippines* (Industrial and Labor Relations Review, 2002), p 24.

1. Legal framework

The 1994 *Labor Law*, which preempted all previous labor laws and regulations at the central, provincial, and municipal levels, formally finalized the break with China's "iron rice bowl"[37] and continues to provide the basic framework for labor relations.[38] The *Labor Law* applies to all enterprises, including SOEs, domestic private enterprises and foreign-invested enterprises ("FIEs"), although regulations specifically relating to FIEs have also been adopted.[39]

Wage Formation

The *Labor Law* grants to all enterprises, including FIEs, SOEs and domestic private enterprises, the right to set their own wages above the government-set minimum wage.[40] Under a 1994 rule and the *Regulations on Minimum Wages in Enterprises,* each province must set a minimum wage that is not less than half the local average wage.[41] Minimum wages therefore appear to vary by locality (province or municipality); there do not appear to be industry or sector specific minimum wages. The *Provisional Regulation on the Payment of Wages* states that wages must be paid in currency and not in goods, service or vouchers.[42]

Under the FIE Wage Measures, FIEs are required to pay employees the "average wage standard" in the same industry in the local area.[43] While the term "average wage standard" does not appear to be further defined, it may be related to a further requirement that wages in FIEs shall be "not less than 120 percent of the average wage paid by state-owned enterprises in the same line of business in the locality."[44] The average wage of all employees must increase progressively in line with the enterprise's financial development; the board of directors must

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[37] The "iron rice bowl" refers to the guaranteed provision of services from the state.

[38] *The Labor Law of the People's Republic of China* (the "*Labor Law*") (July 5, 1994).

[39] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 381, citing to *Regulations on Labor Management of the Foreign Funded Enterprises* (August 11, 1994) ("FIE Labor Law").

[40] *The Labor Law of the People's Republic of China* (the "*Labor Law")* Articles 46-48 (July 5, 1994).

[41] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006.

[42] *Id*.

[43] *The Provisional Administrative Measures on Wage Incomes of Foreign Investment Enterprises*, Article 4 (February 14, 1997) "FIE Wage Measures". *See also Several Opinions on Collective Bargaining in Respect of Foreign Investment Enterprise Wages* (February 14, 1997).

[44] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 393.

take into account the enterprise's productivity, profits, the consumer price index and minimum wage guidelines for the region in setting wages for the enterprise.[45]

Employer Rights and Obligations

Article 16 of the *Labor Law* provide that all employers, including SOEs, are required to negotiate labor contracts with their employees. By 2000, most SOE workers were employed under contract. FIE labor contracts must be filed with the local labor administration. Most FIEs may sign employment contracts and recruit Chinese employees freely. Representative offices of FIEs, which are generally subject to more restrictions than other FIEs, are an exception and must engage an authorized PRC government labor bureau to recruit Chinese employees indirectly.[46]

Under the labor law, which applied to both FIEs and SOEs, employers may terminate a labor contract without advance notice where the employee has failed to meet the contract terms or is seriously derelict in performing his or her obligations, *e.g.*, the employee is absent without cause for a prolonged period of time. After consulting with the trade union, an employer may terminate an employment contract with 30-days' notice where the employee is incapable of performing his or her obligations, *e.g*., the employee develops a long-term illness. *The Regulations on the Labor Management of the Foreign Investment Enterprise*, provides further that an FIE may lay-off workers if it is undergoing bankruptcy or reorganization; laid-off workers are entitled to compensation in the amount of one month's salary for each full year that the worker was employed by the enterprise.[47]

At least with regard to FIEs, commentators have noted that "(m)ost foreign parties find that firing employees is almost impossible without the support of the union and the local labor service bureau."[48] As noted above, SOEs have laid off significant numbers of workers but continue to struggle with the attendant social implications of worker redundancies.

Certain Worker Rights

Workers are afforded the right to choose employment and the right to compensation.

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[45] FIE Wage Measures, Article 5 (February 14, 1997).

[46] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 88. Representative offices, while having the ability to perform some activities, are heavily regulated by the State Council regarding their ability to sign contracts or engage in profit making activities. *See ibid*, p 76.

[47] *Ibid*, p 389-390. The *draft Labor Contract Law* would allow lay-offs under somewhat broader circumstances. *See China Employment Law* (Baker and McKenzie, February 2006).

[48] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006.

Workers may terminate a labor contract for any reason with 30-days' notice, or immediately, if the employer is in violation of either the labor contract or other legal obligations.[49]

Trade Unions, Collective Negotiation, Association and Assembly

The *Labor Law* provides that employees may join or organize trade unions and negotiate collective bargaining agreements.[50] The *de facto* implementation of these rights is discussed below. All collectively bargained contracts must be submitted to the Ministry of Labor and Social Security ("MOLSS"). The *Trade Union Law* provides guidelines for the obligations of trade unions and for mediation between trade unions and employers.[51] While freedom of association is provided for in law, in practice independent unions are not permitted and all trade unions are created under the umbrella of All-China Federation of Trade Unions ("ACFTU").[52] As discussed below, strikes are prohibited as a matter of policy and practice.[53]

The *Constitution* provides for the freedom of peaceful assembly but also stipulates that such activities may not infringe upon the interests of the state.[54]

Dispute Resolution

In accordance with the *Labor Law* and other regulations, labor disputes are required to be resolved in stages.[55] First, the parties are required to engage in consultations. If resolution is not achieved, the parties are required to apply to the enterprise's labor dispute mediation committee, which consists of three individuals chosen by and representing the employees, employer, and the trade union. Barring resolution, parties may then appeal to the local labor dispute arbitration

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[49] Article 31 and 32 of the *Labor Law*.

[50] Article 7and 33 of the *Labor Law*.

[51] *The Trade Union Law of the People's Republic of China* (April 3, 1992 as amended October 27, 2001).

[52] *Country Report on Human Rights Practices 2005, China* (Washington, DC: United State Department of State, 2006), Section 6(a).

[53] *Country Report on Human Rights Practices 2004, China* (Washington, DC: United State Department of State, 2005), Section 6(b) stating that " Neither the Constitution nor the Labor Law provides for the right to strike. The Trade Union Law acknowledges that strikes may occur, in which case the union is to reflect the views and demands of workers in seeking a resolution of the strike. Some observers interpreted this provision to offer at least a theoretical legal basis for the right to strike. However, the Government continued to treat worker protests as illegal demonstrations, indicating that there was still no officially accepted right to strike. In addition, no other types of planned worker action were allowed."

[54] Articles 35 and 51of the *Constitution*.

[55] Article 77 of the *Labor Law*.

commission, which typically consists of representatives of the MOLSS, the official trade union and an economic affairs administrative department designated by the government.

2. Developments in the economy

Wage Formation

Wages in the agriculture, industrial, and service sectors were almost identical in 1980. Wages in all three sectors have both increased and become more differentiated over the subsequent decades.[56] Both minimum wages (set by the provinces) and contractual wages vary by region in line with labor productivity and have been increasing over time as the economy has grown. Wage increases and labor shortages in the highly developed Southeast region have prompted some FIEs to move inland, where wages can be half those prevailing on the coast.[57] Wages in FIEs, SOEs and collective enterprises have all increased over time, with the greatest increases occurring in FIE wages. Wages tend to be higher in the more-efficient FIEs than in SOEs, which, in turn, are higher on average than wages in collective enterprises.[58] In this vein, wages vary across urban and rural areas. For example, average wages in the more-rural TVEs are about 40 percent lower than urban wages.[59]

Wages are also apparently affected by the relative availability of workers at different skill levels.[60] There is a persistent shortage of skilled labor, which has led to turnover rates of almost 50 percent in some industries. As a result, some FIEs have to offer higher wages and better compensation packages to attract and maintain a minimum degree of skill level in their

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[56] Qin, Duo, *Is Rising Service Sector in the People's Republic of China Leading to Cost Disease* (Manilla, Philippines: Asian Development Back, April 2004), p 5.

[57] *How Rising Wages Are Changing The Game in China*, Business Asia, March 27, 2006. See *also Economist Intelligence Unit, Riskwire, China Risk: Labour Market Risk*, August 11, 2006.

[58] Lardy, Nicholas, *Chinese Wages and Exports* (Washington, DC: Senate Democratic Policy Committee Hearing, March 29, 2004). In the manufacturing sector, those who work in FIEs represent 76 percent, those employed by LLC and shareholding enterprises represent 7 percent, those employed by SOEs represent 13 percent and those employed by collective enterprises represent three percent of the business sector (non-agricultural). *See Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 135. Lardy, Nicholas, *Nominal Wages in Manufacturing Enterprises, 1993-2002* (Washington, DC: Senate Democratic Policy Committee Hearing, March 29, 2004).

[59] *Income Disparity in China* (Paris: Organization for Economic Cooperation and Development, 2004), p 119-120. This differential has been attributed to labor market segmentation due to the *hukou* system, lower production levels and investments in TVEs and a generally lower level of worker education. Therefore, a mix of market factors and non-market factors have been attributed to this wage differential. Note that the urban population makes up only 35 percent of the workforce, while the rural population represents 65 percent of the workforce. *See Economic Survey of China* (Paris, Organization for Economic Cooperation and Development, 2005), p 135.

[60] *How Rising Wages Are Changing The Game in China*, Business Asia, March 27, 2006.

workforce.[61] There is a significant shortage of well-trained managers and, as a result, managerial salaries also vary widely by skills and region.[62]

Trade Unions, Collective Negotiation, Association and Assembly

China has a single association of trade unions, the ACFTU, under the auspices of the Chinese Communist Party ("CCP").[63] In practice, independent unions are not permitted and efforts to organize independent unions have led to detention and arrest.[64] China's unions may engage in collective negotiation on behalf of their members, with varying degrees of success since the *Trade Union Law* was adopted in 1992. By 1995, there were less than 11,000 collective agreements; surveys at the time showed that workers had very little confidence in their unions.[65] Workers continue to have no means to formally approve or reject collective contracts and little opportunity to affect the negotiation process, without the formal right to strike or vote on union matters.[66]

The extent of union membership varies by sector. According to the most recent statistics (2000), 90 percent of workers in SOEs and collectives are unionized, 40 percent are unionized in the domestic, private non-agricultural sector, and 70 percent in FIEs. Trade union membership is compulsory in FIEs. However, as the statistic above shows, this requirement has not been fully implemented.[67] Unions may be more willing to exercise their negotiating power against foreign investors than against state-owned firms.[68]

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[61] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006. *How Rising Wages Are Changing The Game in China*, Business Asia, March 27, 2006.

[62] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006.

[63] *Country Report on Human Rights Practices 2005, China* (Washington, DC: United State Department of State, 2006), Section 6 (a).

[64] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006. *See also* Amnesty International. *See also* Diamond, Stephen, *Race to the Bottom Returns: China's Challenge to the International Labor Movement* (Cornell: Cornell Law School Working Papers #10, 2003). *Country Report on Human Rights Practices 2005, China* (Washington, DC: United State Department of State, 2006), Section 6 (a).

[65] Frenkel, Steven and Kuruvilla, Sarosh, *Logics of Action, Globalization, and Changing Employment Relations in China, India, Malaysia, and the Philippines* (Industrial and Labor Relations Review, 2002), p 27.

[66] According to the ACFTU, 673,000 collective contracts had been signed by the end of 2003, covering 1.21 million enterprises and 103 million workers. *News Issue No. 9*, (ACFTU, 2004), http://www.acftu.org.cn/0409.htm. Some trade unons have recently been experimenting with a greater degree of membership involvement, including voting. *Country Report on Human Rights Practices 2004, China* (Washington, DC: United State Department of State, 2005), Section 6(a).

[67] *The Economist Intelligence Unit, Risk Briefing, China Risk: Labour Market Risk*, August 11, 2006.

[68] *Id.*

Strikes are forbidden and protests are proscribed but have nevertheless occurred with increasing frequency, especially in relation to layoffs associated with SOE restructuring and work conditions in FIEs. Such protests are generally not tolerated and are often met with police force or criminal prosecution of the organizers.[69] The government has responded with an increasing number of social programs to ease the problems associated with SOE labor retrenchment as well as increased enforcement of FIE labor obligations.[70]

Labor Disputes and Dispute resolution

Labor disputes are not uncommon and, while 98 percent of these cases were officially resolved,[71] commentators have differed over the effectiveness of the dispute resolution process and workers have reported a low level of trust in the mediation process, viewing unions as inclined to favor management and local governments as overly involved in the dispute resolution process. Recent efforts to reform the labor dispute resolution process have included input from foreign governments, international trade union associations and intergovernmental organizations, such as the International Labor Organization ("ILO").

Labor Mobility

The PRC government employs administrative measures to control geographic labor mobility. Independent research suggests that inter-provincial labor migration flows in China could be ten times the observed rate if administrative barriers – those barriers not due to distance and the inherent costs of moving – were lifted.[72] One important administrative restriction is the system governing permanent residence, known as the *hukou* system. This system historically has been implemented to different degrees by the different provinces and regions. Under this system, identification booklets or cards (*hukou*) are issued by municipal or township government entities. Access to social services and schools is limited to those who hold

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[69] *Country Reports on Human Rights Practice 2004, China* (Washington, DC: United States Department of State, 2005), Section 6(b): The Right to Organize and Bargain Collectively, stating that, "Most worker protests involved actual and feared job losses, wage or benefit arrears, allegations of owner/management corruption, or worker dissatisfaction with new contracts offered in enterprise restructuring. The government took swift action to halt protests." The report describes a number of incidents resulting in legal action by the state against organizers.

[70] *Ibid*, Section 2(b) Freedom of Assembly and Association.

[71] MOLSS's yearly statistical report stated that 226,391 disputes involving 800,000 workers were handled during 2004, increases of approximately 22.8 percent and 31.7 percent, respectively, over the previous year. *Ibid*, Section 6(b) The Right to Organize and Bargain Collectively. Of cases that were resolved, 30 percent were resolved by mediation, 43 percent by arbitration and 27 percent were resolved by other means.

[72] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 112.

a *hukou* within that jurisdiction.[73] Officially-sanctioned changes in residence amounted to only 1.3 percent of the population in 2004, a statistic in stark contrast to the estimated 50 to 200 million migrant workers who are living and working outside their residence.[74] While some highly-skilled workers can afford to purchase a "blue stamp *hukou*," (a city-issued *hukou* which can be purchased by the small percentage of migrant workers who are skilled), this is not a viable option for the vast majority of rural unskilled workers.[75]

This policy has made migration difficult and costly, not only between provinces, but also between rural and urban areas, as well as between towns within a province. Additionally, research has indicated that the *hukou* system imposes severe limitations on sectoral mobility, finding that the greatest distortion in China's labor market is the mobility barrier between agriculture and industry.[76]

The central government has announced reform plans to phase out these labor mobility restrictions, beginning with easing restrictions on obtaining residence in towns with a population of less than 200,000. While this may affect up to 40 percent of the migrants, larger towns are typically a more attractive draw for migration, where many of the larger companies, keen for more labor, are situated.[77] Local *hukou* reform efforts often attempt to balance the demand for labor with the financial constraints of providing social services. For example, Guandong and Zhejiang provinces have abolished the distinction between "rural" and "urban" households *(i.e.*, rural residents will be able to freely migrate to urban areas within the same province), which was previously a restriction to intra-provincial migration. Some very large cities, such as Beijing and Shanghai, have implemented a "high threshold and open door" policy that encourages the migration of highly skilled professionals while imposing stricter conditions on other workers.[78]

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[73] *See* Zhang, Ye, *Hope for Migrant Women Workers*, China Business Review, May-June 2002.

[74] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 112. *Income Disparities in China, An OECD Perspective: Income Disparities in Post-Reform China: A Review of the International Literature* (Paris: Organization of Economic Cooperation and Development, 2005), p 92. Some estimates are as high as 19 percent of the workforce. *See* Hertel, Thomas and Zhai, Fan, *Labor Market Distortions, Rural-Urban Inequality and the Opening of China's Economy* (Washington, DC: World Bank Policy Research Working Paper 3455, November 2004), p 1.

[75] See Zhang, Ye, *Hope for Migrant Women Workers*, China Business Review, May-June 2002. *See also China Integration of National Product and Factor Markets* (Washington, DC: The World Bank, June 13, 2005), p 24-25.

[76] *China Integration of National Product and Factor Markets* (Washington, DC: The World Bank, June 13, 2005), p 33. Further, *see* pages 33-34 stating that "local governments in the TVE sector have clearly erected substantial barriers to labor mobility, resulting in substantial distortion in the labor market."

[77] Some larger towns experimented with abolishing the hukou system, but later re-imposed the restrictions, often due to the reduction in revenue from the loss of user-fees for non-registered users of social services such as schools. *See Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 112.

[78] *China Integration of National Product and Factor Markets* (Washington, DC: World Bank, June 13, 2005), p 25.

Land tenure policies, discussed in greater detail below under factor four, also act as a significant restraint on labor mobility. In short, a migrant worker faces the loss of land-use rights in the original place of residence, a traditional means of maintaining family income, while at the same time is unable to gain access to social services, such as health and education, or even the right to work, in the new "temporary" location.

Assessment of factor

Wages between employer and employee appear to be negotiated, as opposed to government-set, as evidenced by the variability in wages across regions, sectors, and enterprise demands. Certain rights, such as the right to compensation and choice of employment, are afforded to workers; employers, while hampered in the ability to reduce staff, are generally free to make independent decisions regarding labor. However, there are a number of important institutional constraints on the extent to which market forces can act upon the formation of wages. The legal relationship between the government and trade unions inhibits, if not precludes, the union's ability to act as a counterweight to the government's interests in negotiating and resolving labor issues. This signals a significant reluctance on the part of the PRC government to allow the workers' collective strength to come to bear on the negotiation of wages and working conditions. In addition, the restrictions on labor mobility serve to inhibit and guide workforce flows and seriously distort the supply side of the labor market.

Factor Three. The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.

Opening an economy to FDI tends to expose domestic industry to competition from profit-maximizing market-based suppliers, including the management, production and sales practices that they bring. It also tends to limit the scope and extent of government control over the market, since foreign investors, as a general rule, demand a certain degree of autonomous control over their investments.

Prior to China's reform period that began at the end of the 1970s, there was virtually no foreign investment in China. China's establishment in 1980 of the first four SEZs, in which various communist-type economic rules were suspended, created the first opportunities for foreign investors.[79] Nevertheless, in the early days of reform, foreign investors were limited as to which industries they could participate in and were subjected to numerous performance requirements and other restrictions.[80] Since the 1990s, however, and particularly as a result of China's accession to the WTO, China has permitted a broader range of investments into an ever-greater number of its industries, although China's FDI policies are still subordinate to industrial

[79] *The Economist Intelligence Unit, Viewswire China Industry: Still in the Zone,* May 19, 2006.

[80] *Country Commercial Guide: China* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

policy goals. While China still maintains both *de jure* and *de facto* restrictions on FDI, however, China secures a large amount of foreign investment across numerous sectors of its economy. Morever, these investments are increasingly being directed towards China's domestic market, bringing more competition to China's domestic industry.

1. Legal framework

Equity Investments

The 1994 *Company Law*, as amended in 2006, establishes the basic framework for limited liability companies ("LLC") and enterprises limited by shares.[81] An LLC can be formed with one to 50 shareholders.[82] There is no general limitation in the *Company Law* on the percentage on foreign investment in an enterprise, thereby providing the basis for wholly-owned FIEs, and the conversion of an SOEs to an FIE.[83] *The Company Law* permits foreign investors to invest in an existing domestic company in China in several ways. An investor may purchase foreign capital shares of a domestic company in China listed overseas, or alternatively, an investor may purchase shares denominated in RMB but quoted in foreign currency and only held by foreign investors.[84] Recent reforms also permit certain foreign investors to purchase A-shares.[85] These investment vehicles do not require any further resources than the capital to purchase the investment shares and may therefore may be a viable alternative to the other investment vehicles described below.

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[81] Limited liability is when the investor is only liable for the amount for which they invest in the company.

[82] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), at 129, citing to *The Company Law of the People's Republic of China*, (December 29, 1993, re-promulgated December 25, 1999 and amended, effective January 1, 2006). ("The *Company Law*") Enterprises established under the *Company Law* must issue stock certificates and hold shareholder meetings, with the Board of Directors responsible for decision-making. See *Overview of the New PRC Company Law* (Jones Day, May 2006), citing to changes to the *Company Law*, effective 2006, allowing for single shareholding.

[83] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005) at 129 citing to the article 21 of the *Company Law* and at 131, citing to the *Provisional Regulations of the Ministry of Foreign Trade and Economic Cooperation on Certain Issues Concerning the Establishment of Companies Limited by Shares with Foreign Investment* (January 10, 1995). These regulations state that the SOE is required to have been operating for at least 5 years and profitable for three years and the scope and purpose of the enterprise must be "consistent with state policy." *See id.*

[84] *Ibid*, p 130.

[85] *China Update* (Squire, Sanders & Dempsey LLP, December 2005), p 2. (Class A-shares of stock usually provide owners with more rights than class B-shares.) In China, A-shares are only quoted in *renminbi* while B-shares are quoted in foreign currencies. In some instances, a foreigner can purchase more than 10 percent of a company's A-shares if they are deemed to be a "strategic foreign investor." *See The Economist Intelligence Unit, Viewswire, China Risk: Alert: New Market Rules May Cause Surge in M&A*, January 31, 2006.

Wholly-Owned FIEs

Following the 2000 amendments to the *1986 Law on Wholly Foreign-Owned Enterprises* ("WFOE Law,")[86] foreign investors now have greater flexibility in establishing wholly-foreign owned enterprises. For example, WFOEs are no longer required to use advanced technology, export the majority of what they produce, or report their production and operation plans to government officials.[87] In general, a wholly-owned FIE is required to take the form of an LLC. Other corporate forms are subject to government approval.[88] *The WFOE Law* requires that any foreign investment must support China's national economy; foreign investors are prohibited from harming the "social order or public interest of China."[89]

Wholly-owned FIEs are prohibited in certain sectors, such as the press, publishing, radio broadcasting, television, cinematographic industries, post and telecommunications. However, joint ventures ("JVs") may be allowed in these sectors.[90] As discussed below, MOFCOM has significant discretion under law to reject an application for a wholly-owned FIE.[91]

The process of applying for bankruptcy has been extremely vague, but has improved for

[86] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005) at 78 - 79 citing to *Wholly Foreign-Owned Enterprise Law of the People's Republic of China* (April 12, 1986, as amended on October 31, 2000), (the "*WFOE Law*").

[87] *Ibid*, p 80.

[88] *Ibid*, p 79, citing to article 8 of the *WFOE Law*.

[89] *Ibid*, p 80, citing to the *WFOE Law*. As these laws are often interpreted differently by different branches of the central government, it is unclear what constitutes a "prohibited" foreign investment projects or how the phrase "social order and public interest" would be interpreted. *See for example Investment Policy Reviews of China* (Paris, Organization for Economic Cooperation and Development, 2006), p 47- 51.

[90] *See* Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 80. *See also Implementation Regulations for the Wholly Foreign Owned Enterprise Law of the People's Republic of China*, Article 4 (October 28, 1990, as revised April 12, 2001) ('the *WFOE Rule*").

[91] Because of a lack of transparency, the reasons for rejecting may not be disclosed to the applicant. Under *the WFOE Rule*, an application for a wholly-owned FIE may be rejected under the following circumstances: 1) if the establishment of the WFOE would be detrimental to China's sovereignty or the social public interest; 2) if the establishment of the WFOE would endanger the national security of China; 3) if the establishment of the WFOE would violate China's laws and regulations; 4) if the establishment of the WFOE fails to conform with the requirements for developing China's national economy; and, 5) if the proposed WFOE is likely to endanger the environment. *See* Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 80. While some of these restrictions are in line with FDI restrictions in place in some market economy countries, the fourth restriction, if implemented fully, could serve to direct FDI only into those sector of the economy where the government decides to permit competition, as opposed to where FDI would naturally flow.

FIEs since the adoption of *SPC Bankruptcy Case Provisions*, in 2002.[92] However, as discussed below, China passed a corporate bankruptcy law on August 27th which is intended to clarify the procedures for bankruptcy for private enterprises, whether domestic or foreign owned.[93]

The WFOE law provides that wholly-owned FIEs' property interests are protected under law and the government will "not nationalize or expropriate" the assets of wholly-owned FIEs, except under "special circumstances," not further defined.[94] Such enterprises are permitted to remit profits abroad and operate "free from interference," although the government may verify that the enterprise is operating in accordance with its capital requirements and within the scope of its business license.[95]

Joint-Venture with Chinese Partners

China has promulgated laws and regulations for two principal types of joint venture enterprises: contractual (or cooperative) joint ventures ("CJVs")[96] and equity joint ventures ("EJVs").[97] Both CJVs and EJVs must be established as an LLC. Both the *EJV Law* and the *C.V. Law* encourage joint ventures to be export-oriented or high-technology oriented through a variety of tax incentives, such as income tax reduction and tariff exemptions on imported equipment and construction materials.[98] FIEs may repatriate their profits.[99]

Both EJVs and CJVs are no longer required to favor domestic suppliers or maintain a

[92] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 823.

[93] *The Economist Intelligence Unit, ViewsWire, China Regulations: New Bankruptcy Law Approved*, August 28, 2006.

[94] Article 4 and 5 of the *WFOE Law*.

[95] Article 19 of the *WFOE Law. See also* Articles 8, 9, and 15of the *WFOE Rule*.

[96] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 90 citing to *The Chinese-Foreign Contractual Joint Ventures Law of the People's Republic of China* (April 16, 1988, revised October 31, 2000) ("CV Law") and the *Detailed Rules for Implementation of the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures*, (September 4, 1995, as amended October 31, 2000) ("CV Rules").

[97] *Ibid*, p 90 citing to *The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures,* (July 1, 1979, amended April 4, 1990) (the "*EJV Law*") and the *Regulations for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures* (September 20, 1983, amended January 15, 1986 and revised July 21, 2001) (the "EJV Rules").

[98] *Ibid*, p 90-91.

[99] Lui, Andrew, *The Dragon Comes Calling* (Hong Kong: Pinsent Masons, March 2006).

balanced ratio between foreign exchange income and expenditures.[100] Management structure in a C.V. may be determined *via* negotiation. The management structure of EJVs must follow the EJV Law and Rules, where the extent of equity interest generally guides each party's ability to influence management of the operations. All joint ventures are permitted to incur both domestic and foreign debt, provided that any foreign borrowing is registered with SAFE.[101]

Partnerships between two or more Chinese individuals, in which the parties are jointly liable for the obligations and liability of the enterprise, are governed by the 1997 *Partnership Law*.[102] Partnerships with foreign parties are officially subject to the *CJV Law and Rules*, as opposed to the *Partnership Law*. Therefore, foreign investors cannot enter into partnerships in China with Chinese individuals other than joint ventures under the *CJV Laws and Rules*. However, commentators have anticipated that FIEs will be able to enter into partnerships in China as legal reforms deepen, particularly with respect to freedom of contract.[103]

Registration

In contrast to many market economies where corporate registration consists of filing the articles of incorporation with the relevant authorities, foreign investors in China are required to file an application to obtain a certificate of approval from MOFCOM, which is subsequently filed with the local State Administration of Industry and Commerce ("SAIC") branch to obtain a business license. An enterprise cannot operate or exist in China without a valid business license, which defines the "business scope," often narrowly defined.[104] All business activities must operate within the business scope in order for the enterprise to maintain and renew its business license, which is in contrast to most western legal systems, where corporations can generally engage in "any lawful business" as stated in their articles of incorporation.[105] The business license also states the required minimum registered capital. There are significant limitations on the reduction in the registered capital listed in the business license over the operating lifetime of the enterprise; these restrictions may result in assets and capital being tied up in the FIE until

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[100] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 90. *See also The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006.

[101] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 97.

[102] *Ibid*, p *106,* citing to, *inter alia*, *The Partnership Law of the People's Republic of China* (February 23, 1997)(the "Partnership Law").

[103] *Ibid*, p 107.

[104] *The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006.

[105] The Law Society of Singapore, *China Business Law: A Guide for Lawyers and Entrepreneurs (*Singapore, Sweet & Maxwell Asia, 2003), p 129.

dissolution or until the government approves the reduction in registered capital.[106]

Recent amendments to *Company Registration Rules* ease somewhat the burdens of business registration. Registration fees and registered capital requirements are lower (in line with the recent amendments to the *Company Law*) and, for the first time, investors may register by mail, fax or email.[107] Furthermore, a series of State Council decisions in 2004 streamlined the process for registering, verifying and approving foreign investment (both wholly-owned and JVs) in the sectors described below, including vesting more power in local authorities to verify that a given investment meets all requirements.[108]

Legal Restrictions on FDI Flows

As part of its WTO accession, China agreed to provide national treatment, *i.e.*, treatment "no less favorable" than what domestic individuals and enterprises enjoy, to all foreign individuals and FIEs. In December 2004, China fulfilled a key obligation by permitting FIEs to engage in local retail and wholesale trade directly with domestic firms in China. Under previous restrictions, FIEs were forced to trade exclusively with approved middlemen, who operated between foreign and Chinese businesses.[109]

All FIEs must comply with the *Industrial Catalogue Guiding Foreign Investment* (the "Catalogue"), most recently amended in 2004. The *Catalogue* defines what investments are encouraged, permitted, restricted, or prohibited.[110] As discussed below, these categories determine the limitations of the scope of business described in the business license. Business licenses for certain (smaller) "encouraged" and "permitted" investments are verified at the local government level, without a feasibility study, provided a project application report is registered with the State Council. Larger "encouraged" and "permitted" investments are reviewed by the State Council.[111] "Restricted" investments require government examination and approval.

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[106] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago, IL: American Bar Association, 2005), p 133.

[107] *China Update*, (Squire, Sanders & Dempsey LLP, February 2006), p 3, citing to the revised administrative Rules on Company Registration, effective January 1, 2006.

[108] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 54 – 55.

[109] *The Economist Intelligence Unit, ViewsWire, China: Competition and Price Regulations*, April 4, 2006.

[110] *The Catalogue for the Guidance of Foreign Investment Industries* (Beijing: National Development and Reform Commission and the Ministry of Commerce, amended 2004).

[111] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago, IL: American Bar Association, 2005), p 149-150.

2. Developments in the economy

China has formally opened most sectors of its economy to foreign investment, particularly since its accession to the WTO. Investment into most manufacturing industries, for example, is encouraged and foreign investors are granted significant incentives. There are very few sectors where foreign investment is prohibited outright, and these are generally cultural products, media, and defense- and national-security related areas.[112] There is, however, a broader list of industries into which foreign investment is "restricted," meaning that the PRC government reserves the discretion to deny or limit the investment if it does not fit into China's own development plans. These industries include, among others, agriculture, textiles, petroleum, pharmaceuticals, some metallurgy and mining, telecommunications and telecommunications equipment, pharmaceuticals, transport, whole and retail trade, and financial and banking services.[113] Some outside observers have noted that while the catalogue lists which sectors are "restricted," it is not transparent with respect to what the restrictions are and whether, or under what conditions, FDI into these sectors would be allowed.[114]

Other categories in the Catalogue may be equally unclear or complicated by industrial policy initiatives. For example, the iron and steel industry is not listed in the catalogue and would, therefore by default, be considered "permitted," and not subject to foreign investment restrictions. However, a 2005 policy statement, discussed in greater detail below, states that "in principle" foreign investors may not own controlling shares in an iron and steel enterprise in China. The policy statement does not clarify if, and under what circumstances, the government might override this restriction, nor does it define "controlling share."[115]

Along with the central government's formal power to restrict foreign investment into the sectors described above, China's current legal framework governing FDI also provides for significant discretion on the part of government officials to restrict FDI on an *ad hoc* basis. For example, the fact that foreign investors must file for a certificate of approval with MOFCOM for each type of business to be conducted creates an opportunity for the PRC government to limit the business scope of FIEs. Morever, local state interests sometimes act to introduce *de facto* barriers to foreign investment to exclude enterprises with foreign backing that would pose

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112 *The Catalogue for the Guidance of Foreign Investment Industries* (Beijing: National Development and Reform Commission and the Ministry of Commerce, amended 2004).

113 *Id*.

114 *Investment Policy Review of China* (Paris: Organization for Economic Cooperation and Development, 2006), p 47-51.

115 *Ibid*, p 52, also stating that "(i)f it is possible for the Council to enforce an industrial policy, whether published or unpublished, involving tighter restriction on foreign enterprise ownership than in the current Catalogue, then the Catalogue does not provide transparent and trustworthy guidance for foreign investors considering an investment in China."

competition to local favored SOEs.[116] There is certainly increasing opposition to foreign ownership of firms in China, particularly foreign buyouts of domestic firms, although it remains to be seen what effect this will have on FDI.[117] Recently, the PRC government published new rules on foreign takeovers of domestic companies in China that continue to give the government broad discretion to block such takeovers without clarifying under what circumstances the government would do so.[118]

China has been enormously successful in attracting FDI despite these obstacles to foreign investment. In 2005, according to International Financial Statistics, China received about U.S. $79 billion in FDI in 2005.[119] This was up from about U.S. $55 billion 2004, due largely to increased investment in China's financial sector.[120] China has long been a favored destination for FDI, having received over U.S. $40 billion each year since the mid-1990s.[121] While FDI inflows into China amounted to only about U.S. $60 per person or about 3.5 percent GDP in 2005, which is not particularly large by international standards, this must be taken in the context of China's size and economy.[122] China's population far outstrips other reforming economies, and these national figures do not reveal the regional distribution of FDI into China, which is skewed towards the better-developed southeast provinces. Moreover, despite the fact that China's FDI inflows have increased in recent years, foreign investment has actually become relatively smaller compared to the economy since the mid-1990s, due to China's tremendous economic growth.[123]

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[116] "[D]ecision makers who run the affected industries and regions in China have sometimes maintained a high-degree of opposition, both overt and covert, to the entry of foreign competitors, with varying degrees of success. They have sometimes received the backing from government officials, who are keen to ensure the development of national champions and to preserve Chinese control over the "commanding heights" of key industries." *See The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006

[117] *The Economist Intelligence Unit, Viewswire: China Economy: The White Peril*, March 31, 2006. *See also The Economist Intelligence Unit, Viewswire: China Economy: Think-tank Calls to Restrict Foreign Takeovers*, August 4, 2006.

[118] *The Economist Intelligence Unit, Viewswire: China Regulations: Beijing Seeks to Clarify Foreign Takeover Rules*, August 11, 2006.

[119] *International Financial Statistics* (Washington, DC: International Monetary Fund, August 2006).

[120]*Id. See also China's Actual FDI in 2005 revised upward by 12 billion dollars* (Beijing: Agence France Presse, June 9, 2006).

[121] *International Financial Statistics* (Washington, DC: International Monetary Fund, August 2006).

[122] *See*, for example, *Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS* (London: European Bank for Reconstruction and Development, 2005), p 55.

[123] For example, in 1996 foreign investment amounted to almost five percent of GDP in 1996 versus about 3.5 percent of the economy in 2005, despite the fact that absolute levels of FDI were much higher in 2005. *See International Financial Statistics* (Washington, DC: International Monetary Fund, August 2006).

China offers quite generous incentives to foreign investors, particularly in taxation. China's five SEZs, numerous economic and technological development zones, and hundreds of other development zones and designated cities provide an array of tax benefits available to FIEs and which are generally tailored to the development plans for specific regions or industries.[124] While the full range of incentives available to foreign investors involved in various industries in these zones is too complex to describe here, FIEs in these areas are generally subject to an income tax rate of 15 percent to 24 percent, versus the standard 33 percent tax rate for domestic enterprises.[125] Beyond tax incentives, many of these zones offer a more friendly business environment and often have better-developed infrastructure.

The tax advantages for foreign investors *vis-à-vis* domestic enterprises doing business in China, however, can be so large that some of China's "foreign" investment probably originates from within China. For example, Hong Kong and the British Virgin Islands are among the top sources of foreign investment into China, but much of these inflows probably constitutes "round-tripping" domestic capital routed through these jurisdictions to claim preferential tax treatment.[126] After discounting for these inflows and other "foreign" investment from greater China, the total investment flows from other top investors such as Japan, South Korea, the U.S. are still large, but less than the headline FDI figures suggest.[127]

Historically, most investment into China took the form of joint ventures with domestic enterprises, giving China a measure of control over foreign investments. Since 2000, however, the registration of new WFOEs have out-paced that of JVs, with WFOEs accounting for over 70 percent of new FIEs in 2004.[128] Forming new JVs is discouraged by the fact that it can be difficult for foreign investors to find suitable domestic partners. Another possible form of FDI,

[124] *The Economist Intelligence Unit, ViewsWire, China Industry: Still in the Zone*, May 19, 2006. *See also Country Commercial Guide: China* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[125] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p.17.

[126] Yeh, Andrew, *A Roadblock for 'Round-Trips.' Regulators are Cracking Down on an Investment Tactic Used to Avoid Tax, says Andrew Yeh*, Financial Times, April 26, 2006, p10. *See also the Economist Intelligence Unit, Viewswire, China Economy: The Changing Patterns of FDI Flows into China*, March 16, 2006.

[127] Estimates of the amount of FDI that actually orginated in China vary. In 2004, the World Bank estimated that as much as 30 percent of FDI flows into China was a result of round tripping. *See Public Policy for the Private Sector: FDI Trends* (Washington, DC: World Bank, Note No. 27, September 2004), p 2. The Asian Development Bank, however, projected that this number was in the range of 30 to 50 percent. *See* Xiao, Geng, *People's Republic of China's Round-Tripping FDI: Scale, Causes, and Implications* (Manila: Asian Development Bank, Working Paper 7, June 2004), Introduction.

[128] *Country Commercial Guide: China* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

establishing a joint-stock company, is burdened by a complex and restrictive approval process.[129] This trend towards the establishment of more WFOEs is also in line with China's WTO commitments to allow WFOEs to enter a broader range of economic sectors. On a *de facto* level, however, the PRC government has been slow to implement a key commitment to allow WFOEs to engage in wholesale and retail trade. While China adopted new regulations in December 2004 allowing WFOEs to buy and sell directly with domestic firms, MOFCOM had not actually approved any WFOEs to actually enter the wholesale and retail trades as of early 2006.[130]

Foreign investment into China continues to be concentrated in the manufacturing sector, which accounted for more than 70 percent of the total FDI inflows into China in 2003.[131] Whereas foreign-invested manufacturing was once concentrated in labor-intensive goods, recent years have seen increasing foreign investment in capital- and technology-intensive area, spurred in part by various governmental incentives and special preferences discussed above. Compared with other enterprises in China, FIEs are also heavily oriented towards foreign trade: exports accounted for almost half of their output, much higher than for domestic enterprises.[132] In 2005, FIEs accounted for just over 50 percent of China's exports *and* imports.[133] Industrial policies also influence the distribution of FDI. For example, the 2004 Automotive Industry Development Policy, discussed in greater detail below, places a 50 percent equity limit to foreign investment in vehicle manufacturing. However, if approved by the State Council, this limit can be relaxed for vehicle manufacturers intending to export and located in an export processing zone.[134] Ad hoc policy implementation further complicates the business environment for foreign investors. For example, the PRC government announced in March 2006 that it will not approve any capacity expansion in auto production, unless the applying companies meet requirements (unspecified in the announcement) to make local brands and support domestic product development.[135]

Despite the fact that China has become such a prized location for foreign investment, it is still a difficult and high-risk business environment for foreign investors. Foreign firms may find

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[129] *The Economist Intelligence Unit, Country Commerce: China,* 2006, p 45-46.

[130] *Ibid*, p 69-72.

[131] *Country Commercial Guide: China* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[132] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 24.

[133] *Id*.

[134] *Ibid*, p 201.

[135] Batson, Andrew, Fong, Mei, *In Strategic Shift, China Hits Foreign Investors with New Hurdles,* Wall Street Journal, August 30, 2006.

it difficult to navigate the country's complex and often-conflicting regulatory environment.[136] While China is open to FDI in most sectors, China's regulatory environment for business offers ample opportunities for government officials to place *de facto* barriers in the way of foreign owned business, or for well-connected local firms to operate at a considerable advantage. For example, according to a recent study by the World Bank, China has some of the most complicated and heavily regulated licensing procedures in the world.[137] The fact that rules on FDI are not uniform, but rather vary by industry, together with the fact that these rules can be unclear, creates both uncertainty and an avenue for interference at various levels of government. Similarly, foreign investors and importers in general face uneven technical regulations with regard to quality and conformity standards, with such standards being developed in a non-transparent manner. While the PRC government has been promoting the adoption of international standards since 1994, only 32 percent of national standards, on average, were equivalent to ISO/IEC (International Standard Organization/International Electrochemical Commission) standards in 2004.[138]

Moreover, the fact that foreign investment into China is so concentrated in manufacturing and oriented toward external trade is due, in large part, to government policy. China has long encouraged FIEs to export. The law on EJVs encourages exports, and while the law on EJVs no longer requires it, commentators note that many EJV contracts still require that most output be shipped overseas.[139] Whereas FIEs have much greater freedom in their activities than in the past, China's licensing process and array of incentives for favored FDI projects continue to guide and influence the investment decisions of foreign enterprises. While many countries seek to guide foreign investment to serve broader policy goals (such as encouraging investment in economically depressed or underdeveloped areas), the sheer volume of China's set of incentives (and disincentives) suggests that China's FDI policies serve as a part of China's broader industrial policies to a significant extent. International institutions have recently been urging the PRC government to reduce the incentives it offers in order to help balance its future economic growth.[140]

Nevertheless, the fact that there is so much investment into China, and that China has steadily expanded the freedom of foreign investors to choose the form of investment and sectors

[136] *The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006. *See also Fools Rush In* (London: The Economist, August 5, 2005).

[137] *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006), p 17, 119.

[138] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 90.

[139] The law no longer requires that EJV contracts stipulate that most output be exported, but apparently most EJV contracts still do so. *See The Economist Intelligence Unit, Country Commerce: China*, 2006, p 69 and 72.

[140] Batson, Andrew, *WTO Urges New Policies in China* , Wall Street Journal, April 20, 2006, p A6.

in which to invest, indicates that the FDI into China is not solely an extension of state development priorities. Due in part to WTO-driven liberalization, foreign investors have greater freedom to access the domestic market, including the service sector.[141] Even in the export market, where most FDI is still concentrated, FIEs compete with domestic private firms in various sectors.[142] This indicates that while there are still "restricted" sectors where competition from FIEs is constrained, market integration is occurring in many other sectors. These sectors in China are able to reap the efficiency gains of greater competition, international practices, and foreign technical expertise.

Assessment of Factor

China permits all forms of foreign investment, *e.g.*, joint ventures and wholly-owned companies, in most sectors of the economy. Foreign investors are free to repatriate profits and capital and are protected from nationalization or expropriation. Despite being quite open to foreign investment, as shown by large FDI flows over the past decade, China manages foreign investment to a significant extent, guiding foreign investment towards favored export-oriented industries and specific regions, while shielding certain domestic firms from competition. While China is open to foreign investment, China's guidance of FDI flow illustrates the PRC government's continuing efforts to direct the economy.

Factor Four. The extent of government ownership or control of the means of production.

The right to own private property is fundamental to the operation of a market economy, and the scope and extent of private sector involvement in the economy often is an indicator of the extent to which the economy is market-driven. The two key elements under this factor for China are: (1) the extent and pace of privatization of enterprises, and (2) the extent of private land ownership and/or land-use rights.

Prior to reforms, the agricultural sector was consolidated into local communes, with output decisions dictated entirely by state entities. The state allowed for only the barest levels of consumption for the rural population, directing the remaining output to industrial development. The industrial sector, meanwhile, consisted almost entirely of centrally-directed SOEs and collective enterprises owned by rural communities. SOEs essentially functioned as industrial work units, their activities dictated by the government. The government, through the State Planning Commission (SPC), industrial ministries, and provincial bureaus of state ministries, issued targets to SOEs for input-use and output production. While SOEs provided information to the respective government bodies, the information was very poor and targets based on this

141 *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 85.

142 *Ibid*, p 31.

information were unrealistic.[143] SOEs, as extensions of the state, were also the providers of most social services for their workers including housing, health care, education, and pension payments[144]

As stated earlier, reforms began in 1978 - 1979 with the restructuring of the agricultural sector. This included the dissolution of village communes and the allocation of land to rural farming families under the "household responsibility system." Under this system farmers became responsible for tilling the land allocated to them and for providing a quota amount of grain to the local government. Farmers were also allowed to sell any amount that they produced in excess of the quota. As a result, agricultural production increased dramatically. Shortly thereafter, China created its first SEZs, where some of the rigid rules of state planning were suspended, to attract foreign investment and increase the country's export earnings. China realized immediate gains from this phase of reforms, including increased grain production, foreign investment and increased exports.

The government then embarked on the first reforms of the SOEs beginning in 1984. These reforms involved giving firms more autonomy in decision making, making managers more accountable for their firms' performance, and introducing incentives for managers to fulfill production. Much as farmers were granted the ability to sell at a price of their own choosing any above-quota production, firms were allowed to sell above-quota production at their own discretion and retain more of their profits. Gradually, the government introduced more price liberalization. Prices of goods sold above the state quota were decontrolled, and the prices of goods sold within the normal state administrative channels were adjusted to reflect these new market signals on the margins.[145]

This increased autonomy and partial price liberalization created a favorable environment for commerce in rural areas, which had a large pent-up demand caused by years of under-consumption. During the mid-1980s, this resulted in a large increase in the number of collective rural enterprises set up by local governments, known as TVEs.[146] The growth in the number of TVEs helped relieve the state from some of the pressure of its social welfare obligations and created millions of new jobs. Some of these were actually firms started by private individuals who would register the business as a TVE to prevent being discriminated against.[147] Private

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[143] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 47.

[144] *The Economist Intelligence Unit, Country Profiles, China,* 2006, p 32.

[145] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 61.

[146] *Ibid*, p 45.

[147] *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2002), p87.

enterprise was increasingly recognized in China, particularly after Deng Xiaoping's tour of southern China's SEZs, where the dynamism of FIEs greatly impressed him. This led to a proclamation that China would become a "socialist market economy," and to an introduction of modern corporate forms.

Decentralization and autonomy helped encourage local development by providing incentives for local management who had the best on-the-ground information in order to improve performance of their SOEs. However, it also caused a divergence of local and central interests as local government protected their primary revenue sources, *i.e.*, the SOEs under their control, through administrative measures (such as barriers to interprovincial investment and merger and acquisitions) and through their control over local bank lending. As one commentator notes, "(l)ocal governments promoted the development of local firms both when it was appropriate and when it was not."[148] Shielded from hard budget constraints, firms based production less on profit considerations than on employment, market share, and the bonuses of managers. This helped lead to increasing losses among many SOEs in the 1990s, particularly after the Asian financial crisis.

This gave momentum to China's new policy of "keep the large and let go of the small."[149] Under this policy first promulgated in 1995, the PRC government would allow smaller loss-making SOEs to go bankrupt or be sold off. Large SOEs, on the other hand, would receive greater support from the state to become "pillar" enterprises which were intended to lead the economy. Targets were set in 2003 to have SOEs as the top three companies in major industrial sectors, with 30 to 50 of these SOEs to be global competitors by 2010.[150]

Many TVEs also faced the same problems experienced by SOEs, as many were effectively controlled by local governments, particularly after they faced increasing competition from private enterprises.[151] Many TVEs then ran large losses and accumulated debt.[152] Because local governments were ultimately responsible for the finances of the TVEs, local governments closed many TVEs and privatized others.

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[148] Thun, Eric, *Industrial Policy, Chinese-style: FDI, Regulation, and Dreams of National Champions in the Auto Sector* (Journal of East Asian Studies, Vol. 4 No. 3), p 461.

[149] Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), p 3.

[150] Thun, Eric, *Industrial Policy, Chinese-style: FDI, Regulation, and Dreams of National Champions in the Auto Sector* (Journal of East Asian Studies, Vol. 4 No. 3), p 458.

[151] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 97-98.

[152] Ibid, p 16 (at footnote 24), and p 98.

Despite 25 years of reform in China, there is still no formal comprehensive privatization program. Reforms to date have been introduced on an *ad hoc* basis with a gradualist approach to implementation. The pace and focus of privatization reforms in China signal the state's desire to maintain a significant role for the SOE sector, especially in certain sectors.

A. The extent and pace of privatization of enterprises

1. Legal Framework

The law governing SOEs, the *Law on Industrial Enterprises Owned by the Whole People* (the "*SOE Law*"), removed the government from direct control of SOEs, granting legal status to them and defining the state as the owner.[153] Eventually, many SOEs were "corporatized," *i.e.*, converted to joint stock companies and registered under the *Company Law*, which was first introduced in 1994.[154] Over half of all SOEs were corporatized in this way by the end of the 1990s. Corporatization is designed to separate company owners from company management so that the company can be run on a commercial basis and to eventually allow investors (potentially including foreign investors) to purchase limited amounts of shares.[155] The process of corporatization succeeded in raising equity capital for SOEs, but its progress in separating the state from the SOE was disappointing. Newly transformed firms were not immune from further state interference, and their increased autonomy made it easier for managers to expropriate the firms' assets.

As mentioned in factor three above, the *Company Law* was revised effective January 1, 2006. The revised *Company Law* provides more security to minority shareholders by explicitly defining managers' fiduciary duties and allowing minority shareholders to bring civil actions against majority shareholders for abuses of power, such as using company assets for personal benefit.[156]

The Sixteenth National Party Congress presented the *Guiding Principles for State-owned Assets* in 2002, which reinforced the State's role as owner of SOEs.[157] The State-owned Asset Supervision and Administration Commission ("SASAC") was created in May 2003 and manages

[153] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 45.

[154] *Governance in China* (Paris: Organization for Economic Cooperation and Development, 2005), p 308-312.

[155] The concept of separating ownership of a company from its management is intended to give managers autonomy in operational decision making so as to limit interference by owners.

[156] Anderson, Craig and Guo, Bingna of O'Melveny & Myers LLP, *Corporate Governance under the New Company Law: Fiduciary Duties and Minority Shareholder Protection (China Law & Practice, 2005),* p 19.

[157] *Governance in China* (Paris: Organization for Economic Cooperation and Development, 2005), p 305.

SOEs registered under the *Company Law* "on the principle of separating government administration from enterprise management and separating ownership from management."[158] The SASAC "shall not interfere in production and operation" activities, but rather will act as the majority shareholder to take major policy decisions and choose managers.[159] A priority of the SASAC is to improve the performance of SOEs' boards of directors by appointing and removing directors based on performance measures.[160] The SASAC may authorize directors to take independent decisions on "important matters of the company." However, the State nevertheless decides any matter related to the increase or reduction of capital, issuance of bonds or changes in corporate structure, such as mergers, divisions or liquidation. The chairman and vice-chairman of the board are appointed by the SASAC from among the board members.[161]

2. Developments in the economy

China has made progress in privatizing or closing SOEs and collectives, thus creating opportunities for new private enterprises. Whereas in 1995 there were over 300,000 SOEs across all industries in China, there were less than 150,000 in 2005.[162] While this drop reflects SOE consolidation as well as privatization and closure, the withdrawal by the state has been substantial. Moreover, employment in state enterprises fell by almost 40 percent between 1998 and 2003 alone, as 16 million workers were laid off. Collective enterprises have restructured even more rapidly. The number of these enterprises, as well as their share of employment and assets all decreased by more than half between 1998 and 2005, adding to the already substantial withdrawal by collectives in the mid-1990s.[163] Meanwhile, the expanding private sector is making up for the withdrawal of the state.

Measuring the size of the private sector in China is difficult. On the one hand, not all enterprises officially registered as "non-state" are indeed private, as the state may retain a position as the largest shareholder. Conversely, the private sector is larger than the sum of enterprises registered as "private," as that definition excludes many small firms registered as "household enterprises," discussed in greater detail below in factor five. Using the OECD's definition, the private sector accounted for approximately 59 percent of China's GDP in 2003, up

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[158] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 133.

[159] *Ibid*, p 133-134.

[160] *Governance in China* (Paris: Organization for Economic Cooperation and Development, 2005), p. 305.

[161] *Trade Policy Review, People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 129.

[162] *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 95-96.

[163] *Ibid*, p 96.

from 50 percent in 1998.[164]

While the state's withdrawal from many sectors of the economy is impressive, it still retains control over key sectors. The remaining SOEs are generally larger in size than private firms and still account for over half of industrial assets in China.[165] The government also intends to preserve a substantial role in the economy for many of the remaining large SOEs. Government policy is to create and support large SOEs in "core" industries, including energy, defense, metals, motor vehicles, transport, and telecommunication.[166] Particularly in these "core" industries, the state continues to play a major role in decision-making.[167] In order to implement its policy of creating large state champions in these selected sectors, the government has mandated consolidation through mergers and acquisitions, creating large conglomerates or business groups.[168]

Corporate Governance in SOEs

Officially, SOEs incorporated under the 1994 *Company Law* are empowered to make their own managerial, operational and production decisions. The state retains only the authority to appoint, remove, and reward directors. A minority of commercial enterprises are not incorporated under the *Company Law* and still operate under the old system of direct management by government ministries. A primary goal of SOE reforms has been to improve efficiency by introducing market management practices and by separating the ownership of firms from their management in order to restrict the state to the role of owner and limit its interference in the day-to-day operations of the company. In theory, this provides greater autonomy to the SOEs' managers and allows them to make decisions based on market considerations. In practice, however, the CCP still appoints the majority of senior SOE

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[164] The OECD figure is based on a definition of the private sector that excludes collectives, as well as enterprises under the direct or indirect control of the state. *See Ibid*, p 125-127.

[165] Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), p 7.

[166] *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005) p 106.

[167] For example, managers in the four major companies of China's recently deregulated telecommunications industry were forced by the government to take each others' jobs to discourage competition. *See The Myth of China Inc.* (London, The Economist, September 1, 2005). Another example was when in 2000, Sanjiu, a major pharmaceutical company, wanted to lay off 1,500 workers, it was prevented from doing so by local government leaders. *See* Roberts, Dexter, *Buying Binge* (Business Week, Number 3717, January 29, 2001), p 48. *See also The State's Long Apron Strings* (Business Week, August 22, 2005), stating that the CCP sometimes acts as "kind of a 'shadow management.'"

[168] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 90-91.

managers despite a nominal separation of ownership and management.[169] Reforms of enterprises registered under the *Company Law* have generally helped improve corporate governance and efficiency by introducing the motivation for profit and some measures of accountability.[170]

Inefficiency in the State-Owned Sector

Inefficiencies in SOEs can be linked to a number of factors involving a lack of corporate governance, government interference, direct planning, soft budget constraints, and social policy concerns. Between 1998 and 2003, domestic and foreign controlled private companies experienced rapid increases in output while state controlled firms experienced smaller increases, despite the fact that SOEs have more capital.[171] The OECD and McKinsey & Company estimate that aggregate productivity in the state sector is half that of the private sector.[172] While SOEs' rates of return have improved recently from low levels of the late 1990s, SOEs nevertheless continue to earn a lower rate of return than private firms.[173]

SOEs continue to receive a large majority of the loans issued by state-owned banks.[174] Some commentators estimate that a large share of these loans are policy loans directed by the

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[169] "The party appoints 81 percent of chief executives of state-owned enterprise and 56 percent of all senior corporate executives... The Communist party secretary and the chairman of the board were the same person in about half of corporatized large- and medium-sized state enterprises." *See* Pei, Minxin, *The Dark Side of China's Rise* (Foreign Policy, March/April 2006).

[170] Garnaut, Ross, Song, Ligang, Tenev Stoyan, and Yao, Yang, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The World Bank, June 2005), which presents a study comparing factors such as profitability, overdue loans, and labor productivity in firms that have gone through reform, including being registered under the *Company Law*, with those that have not implemented reforms. The analysis shows that, in all areas, reformed firms perform better than non-reformed firms.

[171] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 18, which states that domestically-owned private firms had a five-fold increase in output and a three-fold increase by foreign controlled firms while SOEs' output increased only 70 percent.

[172] *Ibid*, p 86 and 98. The estimate is based on data containing 850,000 observations for Chinese industrial companies from 1998 to 2003. This report also says that "overall productivity is markedly higher for private sector companies be they owned by non-mainland shareholders, other private sector companies or individuals." *See also How Financial-System Reform Could Benefit China* (The McKinsey Quarterly, 2006 Special Edition: Serving the New Chinese Consumer).

[173] *Economic Survey of China*, (Paris, Organization of Economic Cooperation and Development, 2005), p 101-102.

[174] McKinsey estimates that private companies receive only 27 percent of loans but contributed over half of China's GDP. *See How Financial-System Reform Could Benefit China* (The McKinsey Quarterly, 2006 Special Edition: Serving the New Chinese Consumer).

government.[175] SOEs, because of backing from the government, often face soft budget constraints. As discussed below in factor five, loss-making SOEs continue to borrow from state-owned banks to stay in business. This is in stark contrast to a market situation, where, in general, inefficient indebted firms would not continue to receive funding. Such firms would either restructure through bankruptcy or go out of business. According to the OECD, "there remains a large tail of state-owned enterprises that continue to waste investment and drain financial resources from the economy."[176] Moreover, the minority of SOEs that continue to be highly profitable have generally been given monopoly or privileged status over the production or importation of various commodities for which market prices have soared in recent years.[177]

Social Policy Concerns and the Pace of Privatization

As mentioned above, SOEs historically assumed the social obligation of lifelong employment for a state-proscribed workforce, as well as providing social welfare benefits, such as education, housing, medical services and pensions. The cost of providing such benefits to a rapidly aging population is quickly rising, and SOEs are increasingly forced to draw on current revenues to fund social welfare obligations.[178] Recent reforms have aimed to gradually develop a framework for delivering social services apart from the traditional conduit of the SOEs, thereby eventually freeing the SOEs to focus on profitability rather than social welfare programs.[179] Growth in the more-efficient private sector, including the FIE sector (discussed above in Factor 3) and the domestic private sector (discussed below in Factor 5) has partially relieved some of the social pressures through the creation of new employment opportunities.[180]

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[175] Yusuf, Shahid, Kaoru, Nabeshima, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 17. This source estimates that up to 42 percent of all lending in China has taken the form of policy loans.

[176] The "large tail" is a reference to a distribution curve. *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 94.

[177] *The Economist Intelligence Unit, Country Report*: *China*, March 2006, p 26. *See also Are these Profits or Losses?* Financial Times Information–Global News Wire, April 29, 2006.

[178] Chen, Yi and Diwan, Ishac, *When the Bureaucrats Move out of Business: A Cost-Benefit Assessment of Labor Retrenchment in China* (Washington, DC: The World Bank, May 2000), p 5.

[179] For example, a 2002 administrative order, which applies to provincial level SOEs (and not to the larger SOEs under the direct supervision of the central government), requires the separation of social service delivery from SOEs' operations within three years. SOEs in lesser-developed areas were given five years to accomplish this; no deadlines were set for SOEs in rural areas. The SOEs are thereafter required to provide operating funds for these services for three to five years, after which the local governments will provide all the funding.

[180] Frazier, Mark W., *State-Sector Shrinkage and Workforce Reduction in China* (European Journal of Political Economy, Volume 22, Issue 2, June 2006), p 2, stating that "state enterprises shed 40.4 million jobs between 1995 and 2002, while the firms in the "other" and private sector categories increased their payrolls by 16.8 million."

B. Land and land use rights

1. Legal framework

Private land ownership is prohibited in China.[181] All land is owned by some level of government, the distinction being between land owned by the local government or "collective" at the township or village level, as opposed to that owned by the national government (also referred to as state-owned or "owned by the whole people"). In an attempt to introduce productivity incentives, the PRC government separated land ownership from the right to use land. While the respective levels of government (national or local) retain ownership of the land, land-use rights can be owned by individuals and firms. This separation began in the early 1980's exclusively in SEZs, set up to attract foreign investment.[182] In 1986, the government promulgated the *Land Administration Law* (the "*Land Law*"), which allowed for the ownership of land-use rights and, in certain circumstances, their transfer. At the time, this law conflicted with China's *Constitution,* which banned selling, leasing, and transferring land. Accordingly, Article 10, section 4 of the Constitution was amended in 1988 to allow transfer of land-use rights.[183]

The length of time that land-use rights are valid depends on the purpose for which the land is used. In 1984, under the household responsibility system, the "Rural Work Document #1" extended agricultural land-use rights contracts to farmers from short periods to 15 years.[184] In 1993, the government encouraged villages to renew agricultural land-use contracts for a period of 30 years, and, in 1998, revised the *Land Law* to explicitly require such contracts to last at least 30 years.[185] Residential land-use rights are granted for 70 years; industrial production rights for 50 years; educational, healthcare and scientific/ technological research for 50 years; commercial for 40 years and 50 years for all other purposes.[186] Before the term expires, the owner can apply for the land-use rights to be renewed; if not renewed, they revert back to the state or collective. Any buildings on the land or improvements made to the land then become

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[181] Article 9 of the *Constitution*.

[182] Ding, Chengri and Song, Yan, *Emerging Land & Housing Markets in China* (Cambridge, MA: Lincoln Institute of Land Policy, 2005), p 14.

[183] *Ibid*, p 14, 39.

[184] Krusekopf, Charles C., *Diversity in land-tenure arrangements under the household responsibility system in China*, (China Economic Review, 13 2002) p 298.

[185] Ho, Samuel P.S., and Lin, George C.S., *Emerging Land Markets in Rural and Urban China: Policies and Practices* (The China Quarterly, 2003) p 689-690 and *The Land Administration Law of the People's Republic of China,* Article 14 (August 29, 1998).

[186] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Article 12 (May 24, 1990).

property of the state.[187]

The use of rural land is regulated by the *Rural Land Management Act* of 2003.[188] Farmers may transfer land-use rights to other farmers for agricultural use and some lease their land to other farmers for agricultural use, but are not permitted to mortgage their land-use rights.[189] Only state-owned land, as opposed to rural land owned by the collective, is eligible to have land-use rights sold for revenue. Collectively owned land, must be converted to state-owned land before the land-use rights can be sold off.[190] The *Land Law* gives the government clear authority to expropriate land from collectives in the public interest.[191] However, there is no definition for "public interest," giving local governments wide latitude to expropriate land for commercial development.[192] The status of agricultural land can only be changed after it has been expropriated.[193] Local governments act in the dual roles of owners of the agricultural land and as representatives of the state. As such, they can expropriate land from farmers, convert it to state-owned land, and thereafter sell the land-use rights to businesses. This prevents farmers from selling or leasing their land-use rights to commercial enterprises and prevents them from retaining more of the proceeds for themselves. Acquisition of agricultural land requires compensation to the farmers for the land, resettlement subsidies and compensation for attachments to the land as well as unharvested crops.[194] If agricultural land is left untilled for two years, the land-use rights are taken back by the local government without compensation.[195]

Urban land-use rights are regulated by the 1995 *Law of the People's Republic of China on Management of Urban Real Estate (Urban Real Estate Administration Law).*[196] Urban land-

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[187] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Chapter VI, Articles 39-42 (May 24, 1990).

[188] *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 48.

[189] Schwarzwalder, Brian et al., *An Update on China's Rural Land Tenure Reforms: Analysis and Recommendations Based on a Seventeen Province Survey* (Rural Development Institute, December 5, 2001) p 172.

[190] *Law of the People's Republic of China on Management of Urban Real Estate,* Article 8 (January 1, 1995)

[191] *The Land Administration Law of the People's Republic of China,* Article 2 (August 29, 1998).

[192] *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 113.

[193] Guo, Xiaolin, *Land Expropriation and Rural Conflicts in China* (The China Quarterly, 2001) p 424.

[194] Ding, Chengri and Song, Yan, *Emerging Land & Housing Markets in China* (Cambridge, MA: Lincoln Institute of Land Policy, 2005), p 20.

[195] *Land Administration Law of the People's Republic of China*, Article 37 (August 29, 1998).

[196] *Law of the People's Republic of China on Management of Urban Real Estate* (January 1, 1995). *See also* Li, Ling Hi, *Establishing a Socialist Urban Land Market: The Case of Shanghai China* (Cambridge, MA: Lincoln Institute of Land Policy, 2003).

use rights can be purchased from the state by any company, enterprise, organization, or individual *via* three means: negotiation, invitation of tenders or auction.[197] The party receiving the land-use right is then required to use the land in accordance with the contractual terms and to pay land-use fees to the state.[198] Fees vary in accordance with the size, purpose and location of the property. Land use rights may be revoked if business operations cease or if the land remains unused or abandoned for two years.[199] The two types of land-use rights for commercial use are "allocated" and "granted" (also referred to as "conveyed"). Allocated rights are those that are provided for a nominal fee to a state-owned enterprise.[200] An annual land-use fee is also charged for these rights. These rights do not expire and may not be transferred, leased or mortgaged. Allocated land-use rights may not be used by an FIE or a foreign joint venture, even if the domestic firm is majority state-owned. The Provisional Measures for the Administration of Registration of Company's Registered Capital requires that allocated land-use rights held by a domestic company must first be converted to granted land-use rights before being contributed to a joint venture.[201]

"Granted" land-use rights can be bought by an enterprise from the state, this transaction is considered the *primary* market, or can be purchased from private individuals or firms, which is considered a transaction in the *secondary* market.[202] Granted land-use rights may be transferred, leased or mortgaged.[203] They require a large up-front fee but carry no annual fees aside from taxes. If the transaction price is substantially lower than value reflective of the land's economic worth (as determined by the local land administration,) the government has the right to

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[197] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas,* Article 13 (May 24, 1990) and *Law of the People's Republic of China on Management of Urban Real Estate,* Article 12 (January 1, 1995).

[198] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Article 8 (May 24, 1990), and *The Land Administration Law of the People's Republic of China,* Article 4 (August 29, 1998).

[199] *Law of the People's Republic of China on Management of Urban Real Estate,* Article 25 (January 1, 1995).

[200] Ho, Samuel P.S., and Lin, George C.S., *Emerging Land Markets in Rural and Urban China: Policies and Practices* (The China Quarterly, 2003) p 687.

[201] *The Economist Intelligence Unit, Country Commerce: China,* 2006, p 37.

[202] Ho, Samuel P.S., and Lin, George C.S., *Emerging Land Markets in Rural and Urban China: Policies and Practices* (The China Quarterly, 2003) p 688.

[203] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Article 4 (May 24, 1990). *See also Law of the People's Republic of China on Management of Urban Real Estate,* Articles 46 to 55 (January 1, 1995)

repurchase the land-use right.[204] Allocated land-use rights can be converted to granted rights, but this requires a large up-front fee. This conversion makes the land-use rights transferable and mortgageable. If the government exercises its right to expropriate land in urban areas, the grantee must be compensated.[205]

2. Developments in the economy

Agricultural Land

Though national laws allow for the transfer and lease of agricultural land-use rights between farmers, implementation of the rules varies widely by province. Farmers in China do not have secure land-use rights and are severely restricted in what they can do with their land. This stems from practices germane to collective ownership such as "land readjustments" and "land expropriations." Land readjustment occurs when the local party cadre or village leaders reallocate land from one family to another family in the village.[206] This has been a practice in the Chinese countryside since the founding of the PRC in order to maintain a general level of equality between households. While recent national laws prohibit readjustments before the expiration of the mandated 30-year agricultural land-use contracts, readjustments nevertheless continue to occur at the local level.[207] Farmers also face land readjustments and possibly the loss of their *hukou* if they leave their land to search for work in the city, as their land may be reassigned to others.[208]

Land expropriation is a source of major tensions and protests throughout China.[209] Villages and other local governments have often exercised broad, unrestricted powers to

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[204] Ding, Chengri and Song, Yan, *Emerging Land & Housing Markets in China* (Cambridge, MA: Lincoln Institute of Land Policy, 2005), p 15. *See also Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Article 26 (May 24, 1990).

[205] *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas*, Article 42 (May 24, 1990).

[206] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 113.

[207] Schwarzwalder, Brian et al., *An Update on China's Rural Land Tenure Reforms: Analysis and Recommendations Based on a Seventeen Province Survey* (Rural Development Institute, December 5, 2001) p 210.

[208] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005), p 113.

[209] "The majority of grass-roots protests in China, particularly in rural areas, are ignited by unscrupulous government officials and their business cronies stealing land from local residents or siphoning off the compensation promised to them. In search for private fortunes, officials routinely seize land from residents, often violently, to build among other projects, economic development zones where foreign companies are offered open spaced to build plants and offices at below market prices." *See The Economist Intelligence Unit, ViewsWire, China Politics: Beware of Protests Foreigners*, October 25, 2005.

expropriate land from farmers and sell the land-use rights to firms or land developers, often with little or no compensation to the farmer despite the requirement of the *Land Law*. Farmers usually receive only a fraction of the economic value of their land when it is expropriated.[210] Receipts from the sale of land-use rights to an enterprise go to the local government providing an incentive for them to take land from farmers.

Urban Land

An active urban land market is emerging in China. However, many land-use right transfers are conducted illegally.[211] The potential for sizeable profits and the lack of enforcement of land laws create incentives for illegal transfers of urban land in what are known as "hidden" markets.[212] Illegal transfers include renting or selling land that was obtained free of charge or local authorities exchanging land for another asset such as housing or company shares; this allows those who obtain the land to avoid paying a fee to the central government.[213] Despite laws requiring market sales of granted land-use rights, most urban land-use rights continued to be allocated through the late 1990s. In 1996, 103,921 lots (34,048 hectares) were sold through the market system while 289,350 lots (70,266 hectares) were administratively allocated.[214] SOEs have illegally used allocated land-use rights as an asset when attracting foreign investment.[215] Larger cities, however, have increasingly used auctions as a more transparent method of selling land-use rights.[216]

Land Titling and Registration

China has made slow progress in the issuance of land-use certificates in rural areas. In 2001 a survey was taken to measure the extent to which farmers had been issued land-use

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[210] Ding, Chengri and Song, Yan, *Emerging Land & Housing Markets in China* (Cambridge, MA: Lincoln Institute of Land Policy, 2005), p 26. *See also* Guo Xiaolin, *Land Expropriation and Rural Conflicts in China* (The China Quarterly, 2001), p 427-428.

[211] Ding, Chengri and Song, Yan, *Emerging Land & Housing Markets in China* (Cambridge, MA: Lincoln Institute of Land Policy, 2005), p 23-24.

[212] Ding, Chengri, *Land Policy Reform in China: Assessment and Prospects*, (Land Use Policy 20, 2003), p 115.

[213] Ding, Chengri and Knaap, Gerrit, *Land Values and the Emergence of Land Markets in Beijing, China* (Cambridge, MA: Lincoln Institute of Land Policy, 2001), p 3.

[214] Li, Ling Hi, *Establishing a Socialist Urban Land Market: The Case of Shanghai China* (Cambridge, MA: Lincoln Institute of Land Policy, 2003), p 5.

[215] *The Economist Intelligence Unit, Country Commerce: China*, 2006, p 38.

[216] "In December 2003 authorities in Beijing auctioned off 444,300 sq metres of state-owned land", *The Economist Intelligence Unit, Country Commerce: China*, 2006, p 37.

certificates for the required period of 30 years and the extent to which farmers had confidence in the security of their land-use rights. This survey found that only 54.6 percent of farmers had signed thirty-year land-use right contracts and only 46.7 percent of farmers had been issued a copy of the contract.[217] In addition the survey found that many farmers lacked confidence in their land-use rights, especially when they had not signed or received a 30-year certificate.[218]

Assessment of factor

China has made progress in privatizing SOEs and introducing limited market practices to state-owned firms. The government has made a decision, however, to recede from direct state control over certain parts of the economy (particularly across much of export-oriented manufacturing), but to maintain and bolster state control in other areas (such as in finance, energy, and in the "core" or "pillar" industries where the government's policy is to erect state-owned "national champions"). The result is an economy that features both a certain degree of private initiative as well as a significant degree of state-planned and state-driven development. In keeping with the tradition of "keeping the large and letting go of the small," China continues to combine market processes with continued state direction.

Property rights in a market economy should be secure, administered according to law, and accompanied by a reasonable degree of freedom of alienation. China's land laws, regulations, and statements, although often vague and contradictory, seem to support the provision of secure land-use rights to farmers and an open, transparent system for transferring commercial land-use rights. In practice, however, laws and regulations are regularly violated by individuals and local governments. While the private market for land-use rights has grown, SOEs own a significant amount of land-use rights that they received free of charge. Also, commercial land sales are often conducted illegally. In short, property rights remain poorly defined and weakly enforced.

Factor Five. The extent of government control over the allocation of resources and over the price and output decisions of enterprises.

Decentralized economic decision-making is a hallmark of market economies, where the independent investment, input-sourcing, output and pricing actions of individuals and firms in pursuit of private gain collectively ensure that economic resources are allocated to their best (most efficient) use. Prices in such economies tend to reflect both demand conditions and the relative scarcity of the resources used in production.

An important measure of government control over production decisions and the allocation of resources is the degree to which the government is involved in the allocation of

[217] Schwarzwalder, Brian et al., "An update on China's rural land tenure reforms: analysis and recommendations based on a seventeen-province survey" (Columbia Journal of Asian Law, 2002), p 168.

[218] *Ibid*, p 175.

capital. Given that banks are important allocators of capital, especially where equity and bond markets are underdeveloped or non-existent, the degree to which the state exercises control over the commercial banking sector is an important consideration.

For purposes of this factor, the four main issues are: (1) the extent of price liberalization, (2) the status of commercial banking reform, (3) private property ownership, the private sector, and entrepreneurship, and (4) trends in growth and investment.

A. The extent of price liberalization

1. Legal framework

Prior to 1979, the central government set the vast majority of prices. In 1984, the *Provisional Regulations Concerning the Expansion of the Autonomy for State-Owned Industrial Enterprises* allowed SOEs to sell some products produced above their production quotas and charge prices 20 percent above or below state-set prices. This developed into the two-track "dual pricing system," under which the state would retain control of prices for goods distributed through administrative channels and firms would set prices for above-quota production quantities.[219]

The 1997 *Pricing Law*, which gives most enterprises, including SOEs, the right to set their own prices for their goods and service, replaced all laws promulgated under previous price reform efforts.[220] This law was enacted in reaction to a rising number of price wars in consumer markets, and articles 13 and 14 provide prohibitions against dumping, deceptive practices and price discrimination.[221] The pricing law does not apply to interest rates, securities, insurance and FOREX.[222]

Certain price controls continued under the Pricing Law, including fixed (government-set) prices and "guidance prices."[223] Articles 22 through 25 of the Pricing Law provide that private

[219] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 56, 61.

[220] *Pricing Law of the People's Republic of China* (December 29, 1997).

[221] Due to price wars in the auto industry, in 1998, 13 auto makers signed an agreement to follow guidance prices issued by the State Economic and Trade Commission. *Top Firms Reach Controls Deal to End Price War*, (South China Morning Post, Sept 30, 1998), p 7. *The Price Law* was quickly followed by another regulation in 1998 that prohibited selling at below cost. *See* Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 539.

[222] *Pricing Law of the People's Republic of China*, Article 47 (December 29, 1997).

[223] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 125-126. Under guidance pricing, enterprises are permitted to price their goods within 5 to 15 percent of the government-set reference price. *See also* Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-*

and public interested parties may submit information to the state with respect to the setting of guidance prices, to ensure that pricing is in line with prevailing market conditions. The NDRC set prices and guidance prices at the national level, while adjustments are allowed to be made in each province by the local Bureau of Commodity Pricing.[224] Provincial adjustments are permitted because, in the case of both fixed prices and guidance prices, the government bodies must take into consideration production costs, supply and demand, government policies, prices of related products, and limitation on consumers' purchasing power. Further, in 2001, the State Development and Planning Commission (predecessor to the National Development and Reform Commission ("NDRC")) issued measures describing the procedures for holding hearings on pricing, in order to increase transparency in government price setting.[225]

Before China's WTO accession, tobacco, edible salt, natural gas, pharmaceuticals, and certain utilities (such as electricity) were subject to government set prices. Grain, vegetable oil, processed oil, fertilizer, silkworm cocoons, and cotton were subject to government guidance pricing.[226] China agreed, upon its accession to the WTO, that additional products and services would not be added to the list of those subject to price controls and that it would work to eliminate price controls then in effect. It would continue to implement a system of market pricing, except for certain state-controlled commodities listed in Annex 4 of China's Protocol of Accession, such as tobacco, gas and pharmaceuticals.[227] Section 9.2 of the accession agreement states that China must make best efforts to reduce and eliminate controls in all non-named sectors, "except in exceptional circumstances," which must be notified to the WTO.[228] China also agreed to publish any changes to the list of products and services subject to government pricing and guidance pricing in its official journal.[229]

China maintains some import price controls through the use of state trading enterprises ("STEs"). Rules governing STEs are set out in the *Foreign Trade Law* of 2004. This law allows

Invested Enterprises, 2nd edition (Chicago: American Bar Association, 2005), p 16.

[224] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 125-126.

[225] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 540.

[226] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 126.

[227] *Accession of the People's Republic of China, Decision of 10 November 2001* (Geneva. World Trade Organization, November 23, 2001), Section 9.2.

[228] *Id.*

[229] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 126.

the State to restrict import of certain goods to STEs in order to ensure stable domestic supply, stabilize prices, safeguard food safety, and protect the environment and exhaustible resources. Prices for imports that are set by STEs can be considered state-controlled prices. China's WTO Protocol of Accession lists products subject to import through STEs including grain, vegetable oil, sugar, tobacco, crude oil and processed oil, chemical fertilizer, and cotton. Non-state enterprises that have registered and acquired trading rights may import limited quantities of some of these goods, but in 2005, STEs were allocated 90 percent of wheat imports, 70 percent of sugar imports, 60 percent of maize imports, and 100 percent of chemical fertilizer imports. [230]

2. Developments in the economy

Price reforms began in the late 1970s, with the liberalization of price and output decisions in the agriculture sector. In the early 1990s, nearly half of industrial prices were liberalized.[231] By 1999, 86 percent producer prices were set by the market and retail prices were almost completely liberalized.[232] Since then, China has eliminated price controls on most products, with 90 percent of products traded in China free from direct government control. Price controls remain on "essential" goods and services, *e.g.*, energy, pharmaceutical products and some agricultural products. The NDRC, with adjustments from the provincial Bureaus of Commodity Pricing, continue to determine prices for products subject to price controls. Except for those products subject to price controls, prices for wholly-foreign owned enterprises and equity-joint ventures sales inside China were liberalized in 2001.[233]

The *Pricing Law* gives the PRC government flexibility in determining which products and services are subject to guidance pricing. It allows guidance prices for: merchandise that is of great importance to development of the national economy and the people's livelihood; merchandise for which there is a shortage; merchandise supplied by a natural monopoly; prices of public utilities; and, important services of public welfare. *The Pricing Catalogue of the National Planning Committee and State Council* ("*Pricing Catalogue*") lists all products subject to price controls.[234] This list includes: key reserve materials of the state, state-monopolized tobacco, edible salt, civil explosive equipment, some fertilizers, key medicines, educational materials, natural gas, electricity, military materials, important transportation and postal and telecommunications services. Price controls on "key reserve materials" only apply to stocks

[230] *Ibid*, p 82, 279.

[231] *Economic Survey of China* (Paris: Organization of Economic Cooperation and Development, 2005) p 28.

[232] Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 77.

[233] *The Economist Intelligence Unit, Country Commerce*: *China*, March 2006, p 73.

[234] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 126.

held by the government, and currently include grain, vegetable oil, cotton, sugar silkworms, crude oil, processed oil, and chemical fertilizer. The government sets guidance prices for gasoline, diesel and jet fuel and allows actual prices to fluctuate eight percent above or below the guidance price.[235] Another area where the state determines prices is in the electricity sector. While electricity prices are supposed to be set above full cost recovery, the WTO has found that "there is no direct correlation between electricity costs and prices; the latter are apparently determined as much by political and macroeconomic factors."[236] Commentators have also noted that China's electricity pricing policies have diminished foreign interest in investing in new energy capacity in China.[237]

B. The status of commercial banking reform

Until 1979, the PBOC functioned as China's sole bank, dispersing funds to SOEs solely on the basis of government plans and directives.[238] Following the initiation of market reforms in 1979, the government separated four of PBOC's divisions and set up four commercial banks: the Bank of China ("BOC"), the China Construction Bank ("CCB"), the Agricultural Bank of China ("ABC") and the Industrial and Commercial Bank of China ("ICBC"), (collectively, the "Big Four").[239] In the early 1980s, the government formally established a two-tiered commercial banking system, with the PBOC as central bank and the Big Four as commercial banks.[240] In addition, a host of other smaller, officially designated commercial banks and non-bank financial institutions, *e.g.*, rural and urban credit cooperatives, local government-owned joint stock

[235] *Chinese Government Raises Product Prices; Second Move in 'Guidance' Prices so Far this Year*, Platts Oilgram News, Vol. 84 No. 100, May 25, 2006, p 4.

[236] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 187.

[237] *Id*.

[238] Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), 7-8.

[239] *The Economist Intelligence Unit, Viewswire, China: Country Finance*, August 2005, p 15.

[240] The "Big Four" state-owned commercial banks ("SOCBs") are also known as the specialized banks, a reference to their previous divisional roles as part of the PBOC. The specialties of the respective state-owned commercial banks were as follows: The China Construction Bank supplied credit for long term specialized projects, such as infrastructure projects and urban housing development. The Industrial & Commerce Bank of China was the major supplier of funds to China's urban areas and manufacturing sector. The Agriculture Bank of China specialized in financing to China's agricultural sector and providing banking services to farmers, TVEs and other rural institutions. The Bank of China served as the primary bank for foreign-exchange transactions and trade finance.

commercial banks ("JSCBs") and trust and investment companies, were created to serve specific development needs and market niches.[241]

As a result of country-wide economic reforms and government budgetary considerations, SOEs became increasingly reliant on bank loans to finance their operational and investment needs. As bank lending grew, the Big Four enjoyed significant dominance in terms of both deposits and assets.[242] At the same time, however, neither the Big Four nor SOEs operated on a truly commercial basis.[243]

These problems prompted a new round of banking reforms in 1994. The government created three policy banks (the State Development Bank, the Agricultural Development Bank and the Import Export Bank) to separate policy lending from the commercial lending functions of the Big Four.[244] At the same time, the Big Four were encouraged to lend strictly on a commercial basis. The 1995 Commercial Bank Law formalized a 1994 government policy to make the banking system more market-based, and the *1996 General Rules on Lending* reinforced the *Commercial Bank Law* objective of making banks lend strictly on a commercial basis.

At the end of 1997, the government also abolished the mandatory credit plan, under which the PBOC set lower limits on new loans and their allocation to specific sectors, which often supported the operations of loss-making SOEs.[245] Support of loss-making SOEs was also included in the plan. In 1998, this credit plan was replaced with non-binding targets for credit allocation. In theory, banks were then free to lend according to commercial considerations. Going forward, the government would provide guidance only, in terms of new loan volume and allocation. Despite these efforts and reforms, credit continued to be allocated on a non-commercial basis. NPLs accumulated and the Big Four essentially became insolvent. As a result, in 1998, the government injected U.S. $33 billion into the Big Four, and, in 1999-2000,

[241] *China's Growth and Integration into the World Economy, Prospects and Challenges* (Washington, DC: International Monetary Fund, 2004), p 44.

[242] Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), p 7.

[243] Bhattasali, Deepak, *Accelerating Financial Reform Market Restructuring in China* (Washington, DC: The World Bank, December 1, 2002), p 7. *See also* Yusuf, Shahid, Nabeshima, Kaoru, and Perkins, Dwight, *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, DC: The World Bank, 2006), p 62, 73-74.

[244] Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), p 10.

[245] Monetary and credit policy in the 1980's and early 1990's took form of a credit plan which was implemented through a series of credit quotas for each bank, as well as direct bank financing of enterprises. The credit plan created policy that forced state-owned commercial banks to make loans to state-owned enterprise for development projects. *See* Merhan, Hassanali and Quintyn, Marc, *Financial Reform in China* (Washington, DC: Finance & Development, International Monetary Fund, March 1996), p 19.

four state-owned asset management companies ("AMCs") purchased U.S. $169 billion of NPLs at face value.[246] The government began another wave of bailouts in 2003-2004, when it injected U.S. $22.5 billion into the CCB and BOC and sold off a further U.S. $33 billion of their NPLs to the AMCs. In 2005, the government injected U.S. $15 billion into ICBC and sold off another U.S. $85.5 billion of SOCBs' debt.[247]

As discussed below, despite more than a decade of reforms, including repeated bail-outs, the SOCBs have yet to be fully modernized and are still in the process of developing the institutional underpinnings and human resources necessary to operate on a fully commercial basis.[248]

1. Legal Developments

There are five basic laws governing the banking sector in China: The 1995 *Commercial Bank Law*, the 1995 *Law on the PBOC*, the 2002 *Foreign-Funded Financial Institutions ("FFI") Regulations*, the 2002 *Procedures for the Administration of Representative Offices of FFIs,* and the 1996 *General Rules on Lending.*[249]

The 1995 *Commercial Bank Law*, which introduced prudential regulation standards, defines a commercial bank as an autonomous entity with legal person status that is sufficiently capitalized to engage in banking services.[250] Under this law, commercial banks are responsible for their own profits and losses, must protect the interests of their depositors, and are prohibited from being influenced by any level of government.

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[246] Santabarbara Daniel, *China's Banking Reform: An Assessment of Its Evolution and Possible Impact* (Madrid: Banco de Espana, 2005), p 16. *See also* Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), p 10-11.

[247] Garcia-Herrero, Alicia, Gavila Sergio, and Santabarbara Daniel, *China's Banking Reform: An Assessment of Its Evolution and Possible Impact* (Madrid: Banco de Espana, 2005), p 16-17.

[248] *Finance and Development: Next Steps for China* (Washington, DC: International Monetary Fund, September 2005) stating: "(R)ooting out the legacy of government directed lending, and training banks to make lending decisions based on purely commercial considerations, with adequate regard to viability and riskiness of projects remains a major reform challenge."

[249] *General Rules on Loans* (Sino-law.com, August 1, 1996) were enacted to control and regulate activities related to loans, protect the lawful rights and interests of both parties to borrowing and lending, ensure the safety of credit assets, improve the overall benefit of loans utilization. The rules govern types of loans, duration and interest rate of loan, borrower, lender, loan procedure, supervision on bad loans, system of responsibility for loan management, regulation on reservation of lender's rights and liquidation of loans, special provisions for loan management, and provisions of penalty.

[250] *The Commercial Banking Law of the People's Republic of China* (May 10, 1995).

Article 7 of the *Commercial Bank Law* requires that commercial banks examine the creditworthiness of borrowers and ensure the timely recovery of all loans. Although banks are required to independently manage their loan portfolios, Article 34 of the *Commercial Bank Law* paradoxically states that banks are required to adhere to China's "national industrial policies."

The China Bank Regulatory Commission ("CBRC") was formed in 2003 with a mandate to improve supervision and regulation of the banking system. The CBRC has played a major role in formulating and attempting to implement corporate governance and prudential regulation reforms.[251] The National People's Congress ("NPC") passed the *Law on the Supervision of the Banking Industry*, effective February 2004, which describes the CBRC's regulatory mandate and introduced some of the Basel Core Principles for effective banking supervision.[252] At the same time, the Big Four were freed from the previous legal obligations to grant loans for projects approved by the State Council.[253]

Foreign Banks and Joint Ventures

In addition to the above-mentioned laws and regulations, foreign-invested banks are also subject to the FFI Regulations.[254] Foreign banks may provide a broad range of products and services regarding dollar transactions and can conduct limited *renminbi* business with foreign and domestic companies in certain cities, but not with individuals.[255] China's WTO obligations require that all such client and geographic restrictions on foreign banks' *renminbi* business be eliminated at the end of 2006.[256] China committed upon accession to the WTO to impose only

[251] *Law of the People's Republic of China on Banking Regulation and Supervision*, (December 27, 2003) *See also Finance and Development, Next Steps for China* (Washington, DC, International Monetary Fund, September 2005), p 7.

[252] Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), p 12. The Basel Core Principles have become the global standard for quality of countries' banking supervision systems, providing basic principles for an effective banking supervisory system

[253] Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future* (Milken Institute, February 2004), p 12.

[254] The Singapore Law Society, *China Business Law: A Guide for Lawyers and Entrepreneurs* (Singapore, Sweet & Maxwell Asia, 2003), p 47.

[255] *The Economist Intelligence Unit, Viewswire, China: Country Finance*, August 2005, p 15. *See also*, Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd Edition* (Chicago: American Bar Association, 2005), p 9-10.

[256] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 9-10.

"prudential" measures with regard to licensing foreign-invested banks, *i.e.*, there should be no "economic needs" tests or quantitative limits on licensing for foreign-invested banks.[257]

2. Developments in the Economy

Commercial banks play a number of crucial roles in a market economy, especially where capital and bond markets are underdeveloped or nonexistent. By pooling risk and achieving economies of scale, banks reduce the cost of financial intermediation between savers and investors. Banks price risk and, as a general rule, allocate credit to its best use, *i.e.*, to investments with the highest expected return on a risk-adjusted basis. This means that banks should lend more to productive firms and less, or not at all, to unproductive firms. Banks also impose financial discipline on firms, which hardens their budget constraints and forces them to operate efficiently. [258] China's stated goals for banking sector reform have been to develop such banks. However, as one commentator notes, China's banking sector has "fallen short in its task of allocating credit to the most productive players in the economy."[259]

China has the highest level of state ownership of banks of any major economy in the world.[260] The sector's assets are extremely large relative to the size of the economy,[261] which is explained partially by the high rate of China's savings, the bulk of which cannot be invested outside of China due to capital account controls.[262] The Big Four represent over 50 percent of the formal sector's assets and deposits.[263] Limited ownership diversification has been introduced through minority foreign shareholdings in the BOC and CCB and the JSCBs, with JSCBs representing 13 percent of the sector's assets. Foreign banks account for approximately two

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[257] *Ibid*, p 9.

[258] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 25.

[259] *Ibid*, p 9.

[260] *Ibid*, p 35.

[261] 33,662 billion RMB in 2004. *See Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 139. Banking assets were equivalent to 160 percent of GDP at the end of 2004, compared to 77 percent in the United States, 119 percent in Singapore, and 145 percent in Japan. *See Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 30.

[262] *China's Growth and Integration into the World Economy, Prospects and Challenges* (Washington, DC: International Monetary Fund, 2004), p 44. *See also China and the WTO* (Washington, DC, World Bank, 2003), p 182. *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 27. In addition, private parties may be willing to entrust their savings to the SOCBs based on "the widespread belief – probably justified – that officials would not allow any big financial institutions to fail." *See The Economist Intelligence Unit, Risk Briefing, China Risk: Financial Risk*, August 11, 2006.

[263] *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 139.

percent of total assets.[264] Small state-owned institutions, such as rural credit cooperatives, account for the sector's remaining assets.[265]

There are few alternatives to bank loans, as China's equity and bond markets are relatively small and undeveloped.[266] The capital market is used almost exclusively by SOEs and, while listing criteria have relaxed somewhat in recent years, "government regulators still maintain a high degree of discretion over market entry."[267] The corporate bond market remains small, due, in large part, to burdensome government regulations and the lack of private sector participation, particularly by large institutional investors.[268] Therefore, with few alternatives for external financing, the SOCBs carry out the majority of financial intermediation.[269] Furthermore, as discussed in the May 15th memorandum, because investment is a primary driver

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264 *Ibid*, p 139, 151. JSCBs have been experiencing the fastest rate of growth. Year-on-year assets were up 23.7 percent in 2005, compared to 16.4 percent for SOCBs. *See China's Banking Industry Grows*, (London: SinoCast China Business Daily News, February 6, 2006). This asset share refers to the portion of China's total banking sector assets that are directly controlled by banks based outside of China. As such, it does not include foreign purchases of minority shares in the China's SOCBs.

265 While rural credit cooperatives ("RCCs") make up 98 percent of the Chinese banking sector in number, they only control 9-10 percent of banking assets. *See* Barth, James, Koepp, Rob, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future,*(Milken Institute, February 2004), p 7. The performance of these RCCs generally has been poor due to unclear ownership structures, poor corporate governance, and administrative problems. In order to reform this system, the government has moved control of the RCCs from the CBRC to the provincial governments themselves to clarify some of the structural and administrative issues. *See ADB TA To Help Improve Financial Services To Rural Poor In Two PRC Provinces* (Manila: Asian Development Bank, March 1, 2005).

266 *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 14.

267 *Ibid*, p 15 and 45, stating that "Until a few years ago, companies were chosen for IPO by a committee closely linked to the government, and their choice was often influenced by industrial policy criteria… More recently, the regulators have established a more independent committee to approve IPOs." However, the source notes that until recently the government had effectively stopped new listings.

268 *Ibid*, p 51. These restrictions, which were put in place as a reaction to many corporate loan defaults in the 1980's and 90's, include a 14-17 month issuance process, a 20% tax on interest on corporate bonds, as well as a limit of 140% of the bank deposit rate. A further hindrance to the development of the bond market is the lack of institutional investors as well as the "nascent state of credit agencies in China" which make it difficult to properly price debt. This has forced large corporation to use bank-borrowing for financing, which has crowded out small corporations from bank-borrowing. *See Ibid*, p 51-52.

269 China's banks intermediate a significant portion of capital in China. *Ibid*, p 29. A significant share of investment in China is bank-financed, notwithstanding the recent upturn in the share of self-financed investment that may or may not be pro-cyclical in nature, *i.e.*, when retained profits decrease, enterprises may once again turn to the banking sector for continued access to capital for investment.

of China's growth and bank credit is an important source of financing for investment, the state-owned banking sector plays a critical role in resource allocation in the economy as whole.[270]

The PRC government has made impressive headline reform efforts, focusing on improving loan classification standards, bank management and lending practices, financial accounting and reporting, credit risk assessment, and regulatory oversight, with the stated purpose of improving lending decisions.[271] As discussed below, some of these reforms include the introduction of objective criteria and procedures for assessing credit worthiness holding bank officials accountable for loan performance.[272] This includes potential sanctions issued by the CBRC if bank officials fail to meet specific targets for NPL reduction.[273] In order to reduce the influence of local government in the lending process, the approval for larger loans has been moved to higher levels of bank management rather than a loan officer in one of the thousands of decentralized bank branches.[274] Additionally, the first national credit bureau was launched in 2006 to collect more accurate information on potential borrowers.[275] The BOC and CCB were chosen to serve as pilot banks for reform following their recapitalization in 2003, and good progress has been made as they have achieved many of their 2005 quantitative targets, although aided in large part by capital injections.[276]

The CBRC has taken significant steps towards standardizing banking sector practices. For example, lenders that do not meet adequate capital adequacy ratios by 2007 face sanctions,

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[270] Investment as a share of gross domestic profit ("GDP") continues to rise and was over 45 percent in 2004. The ratio of credit to GDP is extremely high and has been growing substantially since the 1990s. *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion* (Washington, DC: International Monetary Fund, November 2005), p 12. *See also China's Growth and Integration into the World Economy, Prospects and Challenges* (Washington, DC: International Monetary Fund, 2004), p 43. *Economic Survey of China* (Paris: Organization for Economic Co-Operation and Development, September 2005), p 138.

[271] Podpeira, Richard, *Progress in China's Banking Sector Reforms: Has Bank Behaviour Changed?* (Washington, DC: International Monetary Fund Working Papers, March 2006), p 3-9.

[272] *Economic Surveys of China* (Paris: Organization of Economic Cooperation and Development, September 2005), p 162.

[273] *Id*.

[274] *Id*.

[275] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 13.

[276] *Progress in China's Banking Sector Reforms: Has Bank Behaviour Changed?* (Washington, DC: International Monetary Fund Working Papers, March 2006), p 3-9, noting that the achievement of these targets was aided by the recapitalization itself, as well as NPL write-offs and sales.

including the removal of senior management.[277] Recently, the CBRC issued a set of risk indicators for trial use in commercial banks' risk-supervision activities. The indicators are set to become mandatory in 2007 after the trial results have been evaluated.[278] In 2004, the CBRC began performing on-site monitoring of large exposures and politically directed lending, introducing a risk-based supervisory system for city commercial banks.[279] More generally, improvements have been made in prudential regulation, especially in regard to loan classification.[280] Moving SOCBs and JSCBs to a five-tiered loan classification system is both an improvement over the previous four-tiered system and is in line with international standards. The new system ties the risk of a loan to its quality by "incorporating forward looking indicators relating to the borrower's ability to repay and requires reassessment in the event of significant change in those conditions."[281] The CBRC has promised to crack down on banks that do not conform to this system and continue to disguise the true quality of their assets.[282] The state and the SOCBs have also initiated a number of training programs to increase bank employees' expertise, including joint programs with the IMF, foreign partnerships, and the hiring of foreign consulting agencies.[283]

In addition, interest rates have been partially liberalized to provide banks with a degree of flexibility in setting lending and deposit rates in order to operate on the basis of commercial considerations. In 2004, the upper band on renminbi lending was raised to 170 percent of the benchmark rate, while the lower band was to be kept at 90 percent. There was no change on the deposit rates, which must be kept at the benchmark rate. In October of the same year, the upper

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[277] *A Great Big Banking Gamble: China's Banking Industry* (London: The Economist, October 29, 2005).

[278] *The Economist Intelligence Unit, Viewswire, China Regulations: New Risk Indicators for Banks*, February 1, 2006.

[279] *Progress in China's Banking Sector Reforms: Has Bank Behaviour Changed?* (Washington, DC: International Monetary Fund Working Papers, March 2006), p 19.

[280] *Ibid*, p 30, stating "prudential standards have been strengthened."

[281] Under the new classification system the Bank of China uses a formal scoring system based on the objective indicators to place the loan in one of five categories. *See Economic Surveys of China, (Paris: Organization of Economic Cooperation and Development, September 2005), p 162.* These categories of loans are passed, special mention, substandard, doubtful, and loss. *CBRC Urges to Further Five-category Loan Classification System* (London: SinoCast China Business Daily News, May 24, 2005).

[282] *CBRC Urges to Further Five-category Loan Classification System* (London: SinoCast China Business Daily News, May 24, 2005).

[283] *IMF Builds Training Center in Dalian* (China Daily, May 27, 2004). *See also China Minsheng Banking Corporation Selects Accenture and SAP to Lead Technology Transformation* (New York: PR Newswire, Nov 28, 2005), p 1.

limit on lending and the lower limit on deposits were both removed. The floor on lending rates and ceiling on deposit rates is scheduled to be lifted gradually between 2006 and 2010.[284]

While the PRC government continues to formulate banking sector reforms and bank managers may be accepting the importance of such reforms, SOCBs have nevertheless been slow to implement the regulatory and operational reforms that would otherwise strengthen transparency in the sector.[285] The CBRC concluded after inspecting eleven banks in 2005 that "it is 'common practice' for banks to ignore regulation and fail to monitor loans and that bad loan levels are not accurately revealed."[286]

A 2006 IMF working paper finds that, despite a decade of reform, "it is difficult to find solid empirical evidence of a strong shift to commercial orientation by the SOCBs."[287] The study found that loan pricing remained undifferentiated, despite liberalization of lending caps.[288] Most new loans in 2005 were granted at or below the government-set benchmark interest rate.[289] Lending by the SOCBs appears to be driven mainly by availability of funds in the form of savings deposits and does not appear take into account enterprise profitability. In fact, credit expansion is actually *lower* in provinces that foster the most profitable enterprises.[290] Research has also found that lending decisions are made on the basis of insufficient information. "When one bank reviewed the loan portfolio of a particular region, it found that for 60 percent of loans made, it could not identify the industry of the borrower, the type of collateral posted, or even who made the lending decision."[291]

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[284] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 31.

[285] *A Great Big Banking Gamble: China's Banking Industry* (London: The Economist, October 29, 2005). *See also China and the WTO* (Washington, DC: The World Bank, 2003) p 184, stating that "(A)lthough improving, the banks have limited capacity to make lending decisions based purely on commercial appraisal of repayment ability and credit risk… The competitive prospects of the state banks are further undermined by their relative inability so far to implement efficiency reforms – for example, by cutting staff as much as required or closing unprofitable branches."

[286] *A Great Big Banking Gamble: China's Banking Industry* (London: The Economist, October 29, 2005).

[287] *Progress in China's Banking Sector Reforms: Has Bank Behaviour Changed?* (Washington, DC: International Monetary Fund Working Paper, March 2006), p 4.

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[288] *Ibid*, p 13.

[289] *Id.*

[290] *Ibid*, p 18.

[291] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 37-39, which notes that implementation of management performance criteria, whereby loan officers and bank managers face consequences for bad loans and incentives to take well-calculated risks, is crucial to China's bank reform efforts.

The private sector receives a relatively small share of credit from the formal financial sector in China. Private companies, whether foreign-owned, domestic-owned or joint ventures, have grown faster than GDP in the last ten years and by some measures, account for 52 percent of GDP but have received only 27 percent of outstanding loans.[292] An OECD study noted that total factor productivity of privately controlled enterprises is approximately twice that of SOEs.[293] Nevertheless, wholly- and partially-owned SOEs continue to receive a disproportionate share of credit.[294]

This lending pattern can be partially explained by a number of legacy and inertia factors stemming from the high level of state ownership in the banking sector and the historical lack of profit-oriented banking operations. For example, the SOCBs suffer from the lack of skilled and experienced bank managers and loan officers. Banks do not have sufficient experience in risk assessment and loan pricing[295] and may be hesitant to lend to the private sector due to the lack of good quality information regarding credit history and financial performance of potential borrowers.[296] Bank managers have more experience in lending to SOEs, and "apparent government backing makes (SOEs) seem like a low-risk option."[297] In addition, despite a public statement from the CBRC that there will be no more capital injections, there is still an implicit deposit guarantee on the part of the government, which may lead to moral hazard.[298]

While some of the misallocation of resources therefore may be attributed to lack of experience or inertia, the continued level of government intervention in bank operations, especially local government, acts as a significant impediment to commercializing the banks. Separating local governments from SOCB lending is a difficult reform to implement due to the

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[292] *Id*, p 11.

[293] *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 86.

[294] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 11. *See also Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 140, stating that "(t)he high degree of state ownership of financial institutions has been accompanied by a dominant emphasis on lending to state owned or controlled enterprises while non-state enterprises have poorer but growing access to external credit. The four SOCBs are particularly heavily concentrated in lending to SOEs."

[295] *A Great Big Banking Gamble: China's Banking Industry* (London: The Economist, October 29, 2005). "[L]oan pricing and credit assessment skills of loan officers remain poor in many bank branches despite recent efforts to improve, and risk management skills are deficient." *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 13.

[296] *Id*, p 13.

[297] *Id*, p 13.

[298] *China's Growth and Integration into the World Economy* (Washington, DC: International Monetary Fund, 2004), p 45. *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 36.

decentralized structure of the large banks, which have thousands of branch offices.[299] Traditionally, local governments have utilized SOCB branch offices as the main source of capital to fund investment projects and support local SOEs, which in turn provided local employment and government revenue.[300] Commentators note that local staff of commercial banks continue to be influenced by local government officials.[301]

Competition in the form of foreign banks is slowly making its way into the banking system, at a pace carefully regulated by the PRC government. While WTO obligations require that all client and geographic restrictions on foreign banks are eliminated by the end of 2006, foreign banks will nevertheless need significant time to build a branch network which will allow them to compete meaningfully in the domestic market. For the time being, foreign banks and the SOCBs will compete primarily in niche markets.[302]

Foreign banks have recently been allowed to purchase minority stakes in certain banks in China, but total foreign purchases of shares in existing SOCBs has been limited to 25 percent.[303] Recent reforms included the public offering of the CCB in October 2005, which raised U.S. $9.2 billion U.S. dollars from foreign investors for 13 percent of its shares.[304] Some domestic banks in China are to be listed on foreign stock exchanges, but majority control will still rest with the

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[299] *Progress in China's Banking Sector Reforms: Has Bank Behaviour Change*d? (Washington, DC: International Monetary Fund Working Papers, March 2006), p 6. *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 35.

[300] *A Great Big Banking Gamble: China's Banking Industry* (London: The Economist, October 29, 2005).

[301] *Economic Survey of China* (Paris, Organization for Economic Cooperation and Development 2005), p 141. "The chief executives of the head offices of the SOCBs are government appointed and the party retains significant influence in their choice. Moreover, the traditionally close ties between government and bank officials at the local level have created a culture that has given local government officials substantial influence over bank lending decisions." *See also People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion* (Washington, DC, International Monetary Fund, November 2005), p 19, stating that "(t)he staff acknowledged the progress made in reducing government involvement in management and business operations of banks. However, more needs to be done, particularly with regard to local governments, to remove this serious impediment to fully commercializing banks."

[302] *Economic Survey of China* (Paris, Organization for Economic Cooperation and Development 2005), p 150-151.

[303] *The Economist Intelligence Unit, Business China: It's so Far, so Good for China's Banking Sector*, March 27, 2006.

[304] *The Economist Intelligence Unit, China Finance: China Shuns West For Its Big Corporate Share Offers*, November 18, 2005. *See also A Great Big Banking Gamble: China's Banking Industry* (London, The Economist, October 29, 2005), noting that despite the 2005 public offering of CCB, it remains essentially a "government agency, plagued by bad debts and corruption."

state.[305] These investments bring market expertise to the management and board of the SOCBs but the foreign-owned shares remain small, thereby limiting the degree of influence over bank operations.[306]

The government has firmly signaled its intention to "retain majority control of the state banks in the long run."[307] In response to an attempt by Citigroup to acquire majority (85 percent) interest in the failing Guangdong Development Bank in 2006, the government initially considered raising the limit on foreign shareholdings, but eventually reiterated its negative stance on foreign investment in even small- and medium-sized banks after debate on the role of foreign investment in China's banks.[308] The CBRC has also affirmatively stated that it will maintain a majority interest in the Big Four SOCBs for at least the next decade.[309]

Given this policy environment, it is not surprising that market reforms have proceeded slowly in China's banking sector. While profitability of the SOCBs is increasing and NPLs were reduced in 2004 (both in absolute value and as a ratio to total loans), these improvements do not necessarily reflect a fundamental reorientation of bank operations, but rather are to a great extent attributable to transfers of bad assets to the AMCs, loan growth, recapitalization and write-offs.[310]

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[305] Foreign interests have acquired around 10 percent of the CCB, ICBC and BOC, and afforded just one place on the board at each bank. *See The Economist Intelligence Unit, Viewswire, China Finance: What are the Prospects for Foreign Banks in China*, March 15, 2006.

[306] Overmyer, Michael, *WTO: Year Five* (The US-China Business Council, The China Business Review, January –February 2006), p 2. Partnership examples include HSBC with Bank of Communications ("BoCom"), Royal Bank of Scotland with BOC, and Goldman Sachs and Allianz with ICBC. *See also A Great Big Banking Gamble*, (London, The Economist, October 28, 2005), stating that " Guo Shuqing, CCB's new chairman admitted shortly after he got the job, that 'more than 90 percent of the bank's risk managers are unqualified.'"

[307] Statement by Wen Jiabao, Chinese Premier, at the National People's Conference. See *The Economist Intelligence Unit, Business China: Go Away, Crocodiles?*, March 27, 2006. CBRC Vice Chair Tang Shuangning is also cited as stating that "We must set limits because we don't want foreign banks to gain control." *See* Overmyer, Michael, *WTO: Year Five* (The US-China Business Council, The China Business Review, January –February 2006), p 28.

[308] *The Economist Intelligence Unit, Viewswire, China Regulations: Foreign Stake Limits May be Abolished*, January 17, 2006. *The Economist Intelligence Unit, Viewswire, China Regulations: Regulator Maintains Stance on Small/Mid-size Banks*, May 10, 2006.

[309] *The Economist Intelligence Unit, Viewswire, China Industry: Government Vows to Retain Stakes in Largest Banks*, April 28, 2006.

[310] *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion* (Washington, DC, International Monetary Fund, November 2005), p 20. *See also Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 14, stating that "Almost 60 percent of this decline (in NPLs), however, is explained by transfers of bad loans from banks into state-owned asset-management companies. The remainder is due to a rapid expansion in bank lending in 2003 and 2004 and to the success of a few banks in reducing their NPLs… but more defaults may be in store for those banks that have seen little change in the underlying factors that lead to poor

C. Private Ownership, the Private Sector and Entrepreneurship

1. Legal Developments

Property ownership is a legal principle fundamental to entrepreneurial activity and functioning markets. The right to acquire, utilize and dispose of property at will is critical to entrepreneurial activity and allows resources to flow to their most efficient use. Without a legal framework that defines and protects property rights in a uniform, non-discriminatory manner, commercial actors find it difficult to engage in business and investment planning. Economic activities shift towards rent shifting and extraction. Resources are not allocated efficiently and markets are quashed.

Property ownership in China currently is divided into three categories under China's law, *viz.*, (1) ownership by all the people, which is equivalent to state ownership; (2) collective ownership; and, (3) private ownership. While recent reforms have attempted to put these ownership forms on equal legal footing, disparities persist between the rights afforded the various ownership types, especially state versus private.

While several rounds of amendments to the Constitution since 1978 have allowed for an increasing scope of rights for individual businesses and private enterprises, private property rights were not explicitly recognized in the constitution until 2003. Article 13 of the Constitution now provides that the "lawful property of citizens shall not be violated. The State shall protect private property rights and inheritance rights of citizens in accordance with the law. The state may, in the public interest, expropriate or requisition private property of citizens in accordance with the law and shall provide compensation."[311] China's official news agency, Xinhua, claims that the amendment put private property "on an equal footing with public property." The previous version of the Constitution stated that public property is not only inviolable, but also sacred, while affording no such protection for private property.[312] These amendments notwithstanding, Articles 6, 7 and 11 of China's constitution currently state that private enterprises are to be a complement to the socialist public economy, which shall remain the "leading force in the national economy."

There have been six draft versions of the *Property Law*, submitted three times to the NPC and even made public for comment, a rare practice. The draft law is highly controversial and in some ways sums up the ongoing debate between law-makers, policy-makers and academics on the role of private property in China. Many are concerned that the lack of differentiation

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lending decisions." *See Progress in China's Banking Sector Reforms: Has Bank Behaviour Changed*? (Washington, DC: International Monetary Fund Working Paper, March 2006), p 9.

[311] Article 13 of the *Constitution of the People's Republic of China* (December 4, 1982, as amended).

[312] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 2-3 and FN 6.

between publicly-owned property and privately-owned property will "cause state assets to lose their dominant place in the national economy, violating the *Constitution*," while others have argued that equal protection of property rights, whether state or private, is necessary for a properly functioning economy. The vice-chair of the NPC standing committee stated that the draft should be revised, attaching "a great importance to protecting state assets, prevent losing them and guarantee farmer rights."[313] It remains to be seen which tack the final draft of the *Property Law* will follow.

Contracts

A key reform for the development of a market economy is a legal framework for the protection of the property rights embodied in commercial contracts. China's contract law has evolved slowly from "a more paternalistic approach of registration and approval of contracts" towards recognizing the freedom to enter into commercial relationships through mutual assent.[314] The *Contract Law*, effective October 1, 1999, repealed the *Economic Contract Law*, the *Foreign Economic Contract Law* and the *Technology Contract Law*.[315] The framework of these prior laws provided different contract rights depending on the parties to the contract, *i.e.,* state entities had different rights and obligations from private domestic parties; foreign parties were subject to different contract rights and obligations than all domestic parties.[316]

The *Contract Law*, touted as a "universal" contract framework, recognizes the fundamental principle of mutual assent as the basis for all contracts but also interjects an element of state oversight by stating that no contract should "disturb social and economic order or damage social and public interests."[317] While many market-economy contract laws include some element of "social and public interest," the requirement that a contract not disturb the economic order is somewhat unusual.

According to the law, all contracts should be in writing (aside from contracts for immediate performance, which may be oral) and only real property and inheritance contracts require notification to the state in order to be effective. While the previous *Economic Contract Law* stipulated a great deal of mandatory language, the *Contract Law* provides a list of general

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[313] *China Update* (Squire, Sanders and Dempsey LLP, March 2006).

[314] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 247.

[315] *Ibid*, p 249, citing *to The Contract Law of the People's Republic of China*, (March 15, 1999) (the "*Contract Law*").

[316] The Singapore Law Society, *China Business Law: A Guide for Lawyers and Entrepreneurs* (Singapore, Sweet & Maxwell Asia, 2003), p 136-145.

[317] Article 7 of the *Contract Law*.

terms that should be included, such as party names and contract terms; “model contracts” are not mandated. Parties may generally have the choice of law other than PRC law.[318]

While these are major positive reforms in pursuit of the freedom of contract, there are several major weaknesses with the *Contract Law* and its implementation. It is unclear whether the *Contract Law* applies to state entities, undermining the universality of the law. Perhaps most importantly, the benefits of the *Contract Law* depend both upon the ability of the judiciary to enforce contractual obligations and on overcoming the influence of *guanxi* (personal connections) in business relations.[319] This is discussed in greater detail below in the section on rule of law under factor six.

Bankruptcy

After 12 years of debate, China passed a corporate bankruptcy law on August 27, 2006 that would apply to all types of enterprises and creditors.[320] Commentators note that it appears that the government will still play a major role in the deciding whether or not SOEs will declare bankruptcy. The law will not take effect until June 1, 2007 and implementation may provide some insight to the laws efficacy.[321] There is currently no unified bankruptcy law in effect.[322] The 1986 *Bankruptcy Law* applies only to SOEs, while the *Company Law* and the *Civil Law* provide an ambiguous legal framework for bankruptcy of private enterprises.[323] In general, the various bankruptcy policies that do exist are weak, not uniformly implemented throughout the country and do not differentiate between the various business entities that operate in China. [324] The regulations in place focus more on employment issues and the reallocation of assets to other economic uses while creditors have circumscribed or no opportunity to participate and there is

[318] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 250-255.

[319] The Singapore Law Society, *China Business Law: A Guide for Lawyers and Entrepreneurs* (Singapore, Sweet & Maxwell Asia, 2003), p 171-172.

[320] *People’s Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion* (Washington, DC, International Monetary Fund, November 2005), p 29.

[321] *The Economist Intelligence Unit, ViewsWire, China Regulations: New Bankruptcy Law Approved*, August 28, 2006. Dean, Jason, *China Puts Creditors First with New Bankruptcy Law*, Wall Street Journal, August 28, 2006.

[322] *People’s Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion* (Washington, DC, International Monetary Fund, November 2005), p 29.

[323] Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 822-823.

[324] *Bankruptcy Reform in China* (Freshfields, Bruckhaus, Deringer, October 2004).

limited involvement of the courts.[325] Ultimately, the uncertainty for creditors raised by such a system may have a chilling effect on entrepreneurship.

Corporate Governance and Shareholder Rights

The *WTO 2006 Trade Policy Review* of China states that "ineffective corporate governance contributes to the misallocation and perhaps excessive use of capital and labor in the corporate sector."[326] According to a 2004 statement by the governor of the PBOC, China faces several critical challenges in improving corporate governance, including the role of government and the CCP, the problem of insider control and ownership, the role of banks as creditors, and shareholder protection.[327]

Recent reform initiatives have indicated a greater willingness to provide for shareholder protection. For example, the *Company Law* underwent a series of wide-sweeping amendments, effective January 1, 2006, including the formal introduction of the legal obligations of fiduciary duties. These amendments increase shareholders' ability to collectively influence matters placed before the board, and generally increase transparency obligations.[328] Importantly, the amendments introduce the concept of fiduciary duties and expand management's civil liabilities, in order to increase accountability to shareholders.[329] Articles 55, 56, 121 and 122 of the *Company Law* provide that employees, unions and shareholders have the right to oversee and evaluate the activities of the company in certain circumstances. Shareholders are now permitted to bring suit if the directors or management violate their obligations. In addition, China's Securities Regulatory Commission has issued a number of administrative measures aimed at improving the protection of minority shareholder rights. The step considered most important by many experts is improving the system for minority shareholder voting on major issues.[330] It remains to be seen how or if these reforms will be implemented.

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[325] *Id.*

[326] *Trade Policy Review, The People's Republic of China* (Geneva: World Trade Organization, February 28, 2006), p 141.

[327] *Ibid*, p 141-142.

[328] *China Update* (Squire, Sander & Dempsey LLP, November 2005), p 2-3.

[329] Anderson, Craig, Guo, Bingna, *Corporate Governance under the New Company Law (Part 1) Fiduciary Duties and Minority Shareholder Protection* (China Law and Practice, 2005), p 19.

[330] *China Update* (Squire, Sander & Dempsey LLP, February 2005), citing to *Several Rules for Strengthening Protection of Interests of Holders of Shares Offered to the Public* (December 7, 2004).

Intellectual Property Rights

Widespread intellectual property rights ("IPR") violations rank among the highest concerns of investors in China. Laws and regulations aimed at protecting IPR have been issued every year since 1982, including a package of laws adopted after China's accession to the WTO in 2001 in order to meet the minimum legal requirement of the Trade-Related Aspects of Intellectual Property Agreement. With a legal framework in place, China has shifted its focus towards enforcement and implementation. The number of IPR cases is increasing; the courts handled 25 percent more IPR cases in 2003 than in 2002. However, the courts still lack the necessary expertise. Seminal cases, such as the January 2006 decision against the Beijing Silk Market, a venue for pirated foreign-branded goods, remain uncommon and the verdicts often are difficult to enforce.[331]

2. Economic Developments

Entrepreneurship

The PRC government has incrementally granted more autonomy for commercially-directed initiative since it began economic reforms in 1978, first on the margins of the state-controlled economy, and later with the introduction genuinely private enterprise. This has helped spur a sustained period of tremendous economic growth, averaging by some accounts almost ten percent per year. While there continues to be debate about China's exact growth figures, by any standard, China's steady economic expansion over the last three decades bettered the lives of hundreds of millions of people. Today, despite continuing limitations on private property rights, the private sector's limited access to bank credit and a difficult legal business environment, entrepreneurship is flourishing in China.

In the first phases of reform, this economic growth was driven by fostering limited entrepreneurial forces within a larger planned and state-dominated economy, such as the "household responsibility system" in agriculture, decentralizing control over SOEs, and through the establishment of TVEs. By allowing market forces to operate on the margins of the planned system, the PRC government created a space for entrepreneurship in China. This greatly expanded output, first in the agricultural sector and then throughout the economy.

Starting in the 1990s, the PRC government began to allow the development of a private industrial sector, which today dominates most of the industries in which the PRC government has not explicitly preserved a leading role for SOEs. Whereas private firms contributed the majority of value added in only 5 of the 23 "non-core" manufacturing sectors in 1998, by 2003

[331] *The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006.

private firms were dominant in all 23.[332] Overall in these industries, according to the OECD, "the private sector employs two-thirds of the labor-force, produces two-thirds of these industries value added, and accounts for over 90 percent of their exports." While the state still has the stated goal to preserve a leading role in the "core industries" of energy, defense, metals, motor vehicles, transport, and telecom industries, the PRC government will also now allow a significant degree of non-state participation even in these sectors.[333]

In the eastern coastal regions that have seen the most impressive transformation to private ownership over the past decade, the private sector now accounts for 63 percent of total industrial value-added, versus only 32 percent in other regions.[334] Across China as a whole, the private sector share of non-farm business value-added rose to 57 percent in 2003 from 43 percent in 1998.[335] Similarly, in employment, as the public sector (SOEs and collectives) shed over 31 million jobs between 1998 and 2003, the private sector more than made up the difference, creating more than 35.5 million new jobs.[336] The private sector is also about twice as productive as directly state-controlled firms (indirectly state-controlled firms are more productive, but still less productive than all forms of private enterprises).[337] There is also evidence that private firms become even more productive as they grow larger, with private firms of over 500 employees being one-third more productive than smaller private firms.

Most private firms in China are quite small. Besides FIEs (discussed primarily in factor three above), China permits two main forms of private business organization: "household" (or *getihu*) enterprises and "private."[338] Household enterprises are micro-enterprises, as they managed by one person or family and may only employ up to seven employees (including two apprentices). Firms employing at least eight employees must register as a private enterprise, and may take the form of sole proprietorships, partnerships, or limited-liability companies. While some of these private enterprises have grown large, formed conglomerates and even purchased

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[332] *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 82. The term "value added" refers to the additional value created at each stage of production, and is calculated by subtracting the value of intermediate inputs from gross output. To take a simple example relevant to our analysis, if a private firm purchases inputs with a value of 5 from a state-owned firm and subsequently sells a finished product at a value of 10, the private-sector share of value would be 5.

[333] *Ibid*, p 96-97, 106.

[334] *Ibid*, p 85.

[335] *Ibid*, p 81.

[336] *Ibid*, p 89.

[337] *Ibid*, p 86, 98.

[338] *The Economist Intelligence Unit, Country Commerce: China*, 2006, p 12.

small SOEs, most are very small, averaging 24 employees in a 2001 census.[339] Household enterprises are even smaller, averaging just two employees. In 2003, China had three million registered domestic private enterprises and 24 million registered household enterprises, (although the relevant authority, SAIC, estimates many more firms exist than it covers in its statistics.)[340]

Despite the efficiency accompanying increased size, a recent OECD survey suggests that only 5 percent of private firms in China employ more than 500 people.[341] According to official statistics, moreover, only two percent of private firms in China employ more than 1000 people.[342] While there is certainly a role for the smallest enterprises to play in every country's economic development, the fact that the private sector in China skews so strongly towards the smallest enterprises is evidence of China's still difficult business environment.

Recognizing this problem, the PRC government recently addressed some of the long-standing problems with the business environment for private enterprises, which should help firms better find their optimal scale. China's official recognition of private property in the *Constitution* was an important step. Just as important have been revisions to the *Company Law* that dramatically reduced the minimum registered capital to set up a new business in China. Prior to this reform, which took effect at the start of 2006, LLCs needed up to 500,000 RMB (about U.S. $12,000) in minimum capital to register a company, depending on the business the company planned to engage in.[343] This minimum capital requirement was 947 percent of income per capita and eighth-highest in the world, which dissuaded firms from registering their businesses, and therein encouraged the continued operation of the smaller and less-efficient "household enterprises."[344]

Under the new reform, however, all new domestic LLCs need only have 30,000 RMB in registered capital and can contribute in installments as well as use non-cash assets to meet the capital requirements. Similarly, the minimum capital required to start a joint-stock company was reduced from ten to five million RMB. These reforms, which were lauded by the World

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339 *Id. See also Economic Survey of China,* (Paris: Organization for Economic Cooperation and Development, 2005), p 82.

340 *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 82.

341 *Ibid*, p 83.

342 *Ibid*, p 87.

343 Li, Yin, and Chau, Debbie, *China: Overview of the New PRC Company Law* (Mondaq Business Briefing, May 4, 2006).

344 *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006), p 11, 199.

Bank, should significantly increase the number of firms that are able to register as limited liability or joint-stock companies, achieving significant economies of scale.[345]

In addition to central government reforms, certain localities also offer a more favorable business environment for private enterprise than others. For example, authorities in the city of Guangzhou has long been known as having regulations protecting and encouraging private firms and in being at the forefront of allowing private firms to engage in a broad range of commercial activities.[346]

Nevertheless, private entrepreneurs continue to face a difficult environment in China. Difficulties include China's complex and burdensome registration and licensing requirements, compliance with which is excessively time-consuming.[347] For example, according a World Bank study, there are 30 procedures that must be completed to collect all the required licenses to conduct business in China, and completing these procedures takes an average of 363 days and costs 126 percent of China's annual income per capita (this cost is unrelated to the reduced minimum capital requirements discussed above).[348] According to the OECD, these complex licensing procedures have led to "long delays, lack of transparency in decisions, favoritism by local governments, and pressure to pay unauthorized fees."[349] Other difficulties in the business environment are explained elsewhere in this memo, and include a lack of access to credit, uncertain enforcement of contracts, an ineffective bankruptcy law, and an institutional culture that generally favors the well-connected.

Ultimately, however, the business environment for entrepreneurs depends on what industry they are involved in. In the areas where the government particularly encourages development (in high-technology, for example), private individuals can have the registration process expedited, receive tax breaks and other incentives, and generally receive favorable treatment.[350] In other industries, however, would-be entrepreneurs face numerous *de jure* and *de facto* obstacles to doing business imposed by various levels of government, and face uneven competition with well-financed SOEs.[351] China's regulatory and institutional environment engenders such seemingly arbitrary variation, with its complex, often industry-specific nature and decentralization of administration.

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[345] *IFC, WB Hail China's Easing of Business Licensing Requirements* (Global News Wire, December 9, 2005).

[346] *The Economist Intelligence Unit, Country Commerce: China,* 2006, p 13.

[347] *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006), p 119.

[348] *Id*.

[349] *Economic Survey of China* (Paris: Organization for Economic Cooperation and Development, 2005), p 82.

[350] *The Economist Intelligence Unit, Risk Briefing, China Risk: Government Effectiveness Risk*, August 11, 2006.

[351] *The Economist Intelligence Unit, Country Commerce: China,* 2006, p 69.

Nevertheless, there is a clear pattern to China's patchwork of regulations and institutions in the business environments that they create. Much as foreign investment is genuinely encouraged in some certain sectors but severely constrained in others, and where SOEs are liquidated in some industries but actively supported in others, the ease with which businesses operate is largely a conscious decision by state authorities (at both the central and local levels). The state has made a clear decision to recede from direct state control over certain parts of the economy (particularly across much of export-oriented manufacturing), but to maintain and bolster state control in other areas (such as in finance, energy, and in the "core" or "pillar" industries where the government's policy is to erect state-owned "national champions"). The result is an economy that features both a certain degree of private initiative as well as a significant degree of state-planned and state-driven development.

There are some similarities between the two spheres of China's economy. As described above, there are ongoing efforts to make the state sector run more efficiently and more like "market" businesses. After rounds of management reform, corporatization, and even sales of minority stakes to private interests, many of China's SOEs today are significantly different than the inefficient monoliths before reforms began. However, all businesses, including China's private sector, operate in the context of a broader economy that continues to feature elements of state-planning.

D. Trends in Investment and Growth

Geographic Trends

Much of China's economic growth stems from the burgeoning southeast region, which enjoys a number of geographic and historical advantages, such as a dense population, traditions of entrepreneurship in light industry, easier access to transport and closer proximity to other Asian markets. Because of the heavy state involvement in industry in the northeast, domestic investment in the southeast was below average until the late 1980s. However, with the opening of the economy, the relatively freer business environment in the southeast became a comparative advantage that attracted both domestic and foreign investment, initially into light industry, but more recently into heavy industry as well.[352] With growing economic and income disparity between regions, the PRC government has created a number of policies for supporting economic development in other regions that are lagging behind.

1999 marked the official start of the PRC government's "Go West" policy aimed at developing the poorer western regions to redress the growing regional disparity in

[352] *China: Facilitating Investment and Innovation: A Market Oriented Approach to Northeast Revitalization* (Washington, DC: The World Bank, February, 2006), p 5.

development.[353] Concurrent with attracting FDI into the region, which is the core of the "Go West" policy, the PRC government also has been developing the essential infrastructure (*e.g.*, roads, telecommunications, water, etc).

The PRC government embarked upon the northeast revitalization program in October 2003 to revive the region that was once the heartland of China's heavy industrial sector. Unlike the "Go West" Campaign, which aims to encourage the role of private enterprise, the main thrust of the northeast revitalization program is to increase the competitiveness of ailing SOEs through technological upgrades and product research and development.[354] SOEs represent 60 to 80 percent of industrial output in the northeast provinces, compared with about 25 percent in the southeast provinces, and commentators attribute the limited success of the revitalization program to the continued role of the government in the direct management of the region's enterprises.[355] SOEs in the northeast are characterized by overcapacity, enabling them to sell at low prices. These SOEs also enjoy a disproportionate share of access to financial resources, despite having the highest ratios of NPLs in the nation.[356]

The greatest disparity in access to resources, however, exists in the urban – rural divide, rather than across different geographic regions. For example, the rural non-farm sector, which includes commercial activity such as rural industry (often light industry), construction, transportation and retail, is experiencing the fastest growth in labor and capital productivity. Marginal returns on capital is highest in the rural non-farm sector, at 106.2 in 2001, as compared with 20.4, 15.5 and 13.7 for urban industry, urban service and agriculture, respectively. Capital productivity is higher in the rural non-farm sector than all other sectors (perhaps because of the historic lack of access to capital.) Nevertheless, the sector remains substantially under-invested

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[353] *Foreign Investment in China's Regional Development: Prospects and Policy Challenges, Improving Investment Promotion in Western China* (Paris: Organization for Economic Cooperation and Development, October 2001), p 1.

[354] *The Economist Intelligence Unit, Business China, China Economy: Development Still Lags in the Northeast*, June 9, 2005.

[355] "But the program for Northeast "revitalization" so far seems to place greater emphasis on continued government direction – e.g., designation of "pillar" industries and priority firms; financing development of raw materials and equipment production bases; and direct involvement in financial and business services support for SMEs. Five decades of government interventions have resulted in a Northeast economy somewhat lacking in vitality. The lesson from the contrast with the Southeast seems clear: Northeast development would benefit from less government direction and more emphasis on market-led investment supported by appropriate public-private partnerships..." *See China: Facilitating Investment and Innovation: A Market Oriented Approach to Northeast Revitalization* (Washington, DC: The World Bank), p 8. *See also The Economist Intelligence Unit, China Economy: Development Still Lags in the Northeast*, June 9 2005.

[356] *China: Facilitating Investment and Innovation: A Market Oriented Approach to Northeast Revitalization* (Washington, DC: The World Bank), p 13-14.

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and capital continues to flow to urban enterprises.[357] This trend is observed across all regions, according to a World Bank study, which states that "evidence indicate that the greatest disparity is in the rural-urban division and not in the coastal-western inequality.[358]" Banks may have once neglected the rural areas in favor of the urban areas due to the interest rate caps that had previously acted as a constraint on lending to smaller enterprises. However, as noted above in the section on banking reforms, banks have not changed their lending behavior despite interest rate liberalization in 2004 and publication of studies showing the greater returns to be gained from investing in the rural non-farm sector.

Ownership and Capital Allocation

As discussed above in the section on bank reforms, there is also significant disparity between efficiency, output and financing across enterprise ownership-types. For example, according to one estimate, SOEs wholly-owned by the government account for 23 percent of GDP but 35 percent of corporate loans outstanding, corporatized SOEs account for 19 percent of GDP but 27 percent of loans, and collective enterprises account for 6 percent of GDP but 11 percent of loans. The study estimates that private enterprises, both domestic and foreign, collectively account for 52 percent of GDP but only 27 percent of loans.[359]

The SOE share of bank lending is difficult to explain on a commercial basis. While the rate of return earned by industrial SOEs rose from five percent in 1998 to 10 percent in 2003, most of this increase is accounted for by a minority of companies. Highly profitable SOEs are generally monopolies controlling the production or importation of various commodities, the world prices of which have soared in recent years.[360] Over 35 percent of SOEs are not earning a positive rate of return, the median rate of return was only 1.5 percent in 2003, and almost two-thirds failed to earn a return of at least five percent.[361]

Moreover, private enterprises were found to be more than twice as productive as wholly state-owned enterprises. Productivity increases with each form of ownership that moves progressively away from direct state-ownership, *viz*., corporatized enterprises with majority state ownership are 46 percent more productive than wholly state-owned enterprises; corporatized

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[357] *China: Integration of National Product and Factor Markets* (Washington, DC: The World Bank, June 13, 2005), p 44, 52-53.

[358] *Ibid*, p 54.

[359] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 11.

[360] *The Economist Intelligence Unit, Country Report*: *China*, March 2006, p 26. *See also Are these Profits or Losses?* Financial Times Information–Global News Wire, April 29, 2006.

[361] *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 19 and 40.

enterprises with minority state ownership are 70 percent more productive; and, collective enterprises are nearly as productive as private enterprises.[362] Nevertheless, comparing the respective bank loan shares with these productivity measurements indicates that access to credit is inversely related to productivity.

Sector Trends

Excess capacity, partly resulting from excessive fixed-asset investment, characterizes a number of China's industrial sectors. As discussed above in the section on privatization, the policy of decentralization has led to local government protection of their primary revenue sources, *i.e.*, the SOEs under their control, through administrative measures (such as barriers to interprovincial investment and mergers and acquisitions) and control over local bank lending.[363] The result of this local protectionism has been industry fragmentation, with inefficient production segmented across different localities. While some of the regional barriers are in the process of being dismantled, over-investment and excess capacity continues to plague certain sectors.

Recognizing this problem, the State Council issued the *Circular on the Accelerating the Restructuring of the Sectors with Production Capacity Redundancy* in March 2006, which notes that some sectors, such as iron and steel, cement, aluminum and automobiles, "make such blind investment and inefficient expansion that they have incurred production capacity redundancy, which has turned into a predominant problem in the economy." The circular states that "the state has, in the process of carrying out the macro control, accumulated the relevant experience to coordinate industrial policies with other economic policies," in order to accelerate the restructuring of these sectors. The plan envisions that the state will promote "market mechanisms" as well as strictly control investment in fixed assets and the initiation of new projects. Production capacity redundancy will be eliminated "through selection."[364] Under the plan, the state will promote the creation of large enterprise conglomerates through mergers and acquisitions.[365]

Industrial policies are not uncommon in a market economy, nor are the establishment of guidelines for investment and development. For example, the auto sector (discussed in more detail below) is often a target for industrial policies in growing economies, as it creates extensive supply chains with other sectors of the economy. China's industrial policies, however, clearly

[362] *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey & Company, May 2006), p 61 citing to *Economic Survey of China,* (Paris, Organization of Economic Cooperation and Development, 2005).

[363] Thun, Eric, *Industrial Policy, Chinese-style: FDI, Regulation, and Dreams of National Champions in the Auto Sector* (Journal of East Asian Studies, Vol. 4, No. 3), p 455, 460-461.

[364] *Circular of the State Council on Accelerating the S tructure of Adjustment of the Industries with production Capacity Redundancy*, Article 3 (March 12, 2006).

[365] *Id.*

exemplify the state's extensive levers of control over development, restructuring and investment. These policies serve as vehicles by which the PRC government can pick winners and losers within each sector as well as administratively guide resource allocation, as opposed to allowing market forces (such as hard budget constraints, competition and bankruptcy) to guide actors' choices of whether to exit or enter the market, expand or contract operations, or develop new products and technologies.

The Auto Sector

China first designated the auto sector as a "pillar of the national economy" in 1986, and formalized an auto policy in 1994, with the objective of consolidating production into three large and three small producers.[366] Instead of a consolidated industry, by 1998, there were 115 vehicle assembly plants in China. Only five of China's 31 provinces did not have a local plant at the time.[367]

Local protectionism played a role in the creation of excess capacity in the auto sector in China. While the central government may have had the control to prevent a firm from expanding into other regions, local governments could provide the necessary approvals for continued local production, direct other local SOEs to purchase autos locally or increase fees associated with purchasing non-local autos.[368] The close relationships between the management of the firms and the local government ensured continued funding for the firms and continued revenues for the local governments.[369]

Despite the mushrooming number of auto enterprises over the past 20 years and the large flows of FDI into the sector,[370] consolidation has occurred. In many cases, the central government mandated consolidation by forcing poorly-performing smaller firms to join one of

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[366] Wang, Hua, *Policy Reforms and Foreign Direct Investment: The Case of the Chinese Automotive Industry* (Institute of International Integration and Industrial Economics), p 3.

[367] Thun, Eric, *Industrial Policy, Chinese-style: FDI, Regulation, and Dreams of National Champions in the Auto Sector* (Journal of East Asian Studies, Vol. 4, No. 3.), p 462.

[368] *Ibid*, p 461-462.

[369] For example, "Until 1995, the SAIC president served concurrently as the director of the Municipal Localization Office, a role that not only gave him control over the massive Localization Fund (and obviously simplified the process by which SAIC firms applied for funds), but he was also in charge of the government bureaucracy that oversaw the auto industry. SAIC managers were appointed by the municipal government – until 1997, it reported to the Shanghai Economic Commission and the rotation of leaders between SAIC and high-level municipal posts ensured that there was no divergence of views within the leadership of Shanghai's auto industry." *See Ibid*, p 464.

[370] Gallagher, Kelly Sims, *Foreign Technology in China's Automobile Industry: Implications for Energy, Economic Development, and Environment* (China Environment Series: Issue 6), p 1. *See also The Economist Intelligence Unit, Viewswire, China Automotive: Soaring Automotive Production Raises Concerns*, June 5, 2006, referring to significant overcapacity this sector in the past few years, with shrinking profits.

the three major groups rather than exit the market. The acquiring firms often opposed the mergers, not welcoming the addition of inefficient production capacity.[371] Therefore, while industry-wide production remains fragmented across many firms, it is increasingly concentrated in the three major groups identified by the central government as the sector's "winners:" the China FAW (First Auto Groups) Group Corporation; Dongfeng Automotive Group; and, the Shanghai Automotive Industry Corporation ("SAIC").

The 2004 *Automobile Industry Development Policy* (the "2004 Auto Policy") is designed to both encourage the development of automobile trade as well as cool the overheated sector by "letting the market play its role of allocating resources and leaving macro-level control to the government."[372] Similar to the forced mergers described above, the administrative measure envisioned by the plan go beyond the reform measures of imposing strict market discipline. "Large automobile enterprise groups" may draft their own development plans, but these plans shall be examined by the state for implementation.[373] The policy creates barriers to market entry, as the state will only approve the launch of new investments meeting certain production requirements. While not prohibiting automobile imports, the policy places significant functional limitations on sales and distribution channels for importers by requiring them to establish complete distribution networks for their products. In addition to the 2004 Auto Policy, China increased restrictions on FDI that both curb investment and attempt to prevent foreign corporations in joint ventures from producing at levels that do not create excess capacity.[374]

Steel Sector

The capacity of China's steel makers, the majority of which are wholly or partially state-owned, expanded on an unprecedented scale between 2000 and 2005 leading to significant excess capacity. A number of policies have led to this capacity problem, including government-directed mergers and acquisitions (instead of closure or liquidation) and favorable treatment by SOCBs, such as debt-for-equity swaps and debt forgiveness regarding non-performing loans.[375]

[371] Thun, Eric, *Industrial Policy, Chinese-style: FDI, Regulation, and Dreams of National Champions in the Auto Sector* (Journal of East Asian Studies, Vol. 4, No. 3), p 463.

[372] *The Automobile Industry Development Policy of the People's Republic of China*, Article 1 (June 1, 2004).

[373] *Ibid*, Article 6 (June 1, 2004).

[374] These rules include requiring that automakers national sales' be at least four-fifths of productive capacity to be approved to build new plants. If a new plant is approved, the minimum investment is two billion yuan with most money being focused in research and development. Finally, the government is requiring that companies invest in the development of local brands. *See* Oliver, Chris, *Beijing Worries Over Automakers' Expansion* (Hong Kong: Market Watch, May 31, 2006).

[375] *Debt-to-equity Swap Brings Economic Results to Steel Firm*, (People's Daily Online, June 7, 2001). *Report to the President, Global Steel Trade: Structural Problems and Future* Solutions (U.S. Department of Commerce, 2000), p 151. Provincial governments and SOCBs have also shown a willingness to forgive loans to steel producers. *See also Reforming China's Enterprises* (Paris: Organization for Economic Cooperation and Development, 2000), p 78.

As with the auto sector, the over-investment in steel is exacerbated by the incentives and involvement of local officials.[376] For example, the PRC government's reluctance to allow large SOEs to go bankrupt has hindered the least efficient producers from exiting the market.

The 2005 *China Iron and Steel Industry Development Policy* (the "Steel Policy") outlines China's comprehensive policy for rationalization of its steel industry, with objectives and policy initiatives for managing the development of China's state-owned steel enterprises. In particular, Article 20 calls for the strategic reorganization of China's largest steel producers with the 2010 goal of two 30 million-ton and several 10 million-ton level "internationally competitive" business groups. Like the 2004 Auto Policy, the Steel Policy does not aim merely to support strict market discipline which would eventually cool the overheating sector and force the exit of inefficient production. Rather, the Steel Policy 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.[377]

Overview of Sector Trends

Fragmented and/or inefficient production and ambitious government industrial development plans characterize the auto and steel sector in many countries. However, China's industrial development plans targeting these sectors is illustrative of the considerable levers of control the PRC government still exercises over the economy and the direction of its development. In its attempt to fix the structural problems such as excess capacity, the central government is using administrative means, such as limiting bank funds and land use and forcing mergers and acquisitions. The central government also aims to develop and grow these sectors through upgrading technology, trying to balance the product mix and picking winners and losers using, again, primarily administrative measures.

The central government's reliance on administrative measures, as opposed to allowing market forces to guide the development and restructuring of the sectors, is made necessary by a weakness or absence of the legal and institutional factors that underlie markets, *e.g.*, rule of law and property rights, hard budget constraints and meaningful bankruptcy laws. At the same time, these administrative measures consistently fail because the absence of these legal and institutional factors also makes it possible for local governments to use administrative measures to increase investment, capacity and production in the steel and auto sectors, in large part without regard to commercial considerations. The ongoing struggle between the central government and local governments in China over control of resource allocations is one of the primary determinants of market outcomes in the steel and auto sectors.

[376] *'Overcapacity Causes Concern' in Steel Industry* (Beijing China Daily Online, June 9, 2004).

[377] G/SCM/Q2/CHN/15 Transitional Review Mechanism Pursuant to Section 18 of the Protocol on the Accession of the People's Republic of China: Questions from CANADA, MEXICO and the UNITED STATES to CHINA Concerning Subsidies (Geneva: World Trade Organization, October 13, 2005).

Assessment of factor

The era of China's command economy has receded and the great majority of prices are liberalized. There is increasing evidence at both the micro-and macro level of some market-based resource allocations. The state-owned sector is shrinking in relative terms, with retrenched labor being absorbed by other sectors. A limited number of SOEs are profitable and competitive. The growing private sector is productive, profitable, and increasingly driving economic growth. Bank lending to the private sector has increased at the margin, growing from nearly zero credit extended to the private sector in the 1980s.

Nevertheless, the PRC government, at all levels, remains deeply entrenched in resource allocation. Importantly, the various levels of government in China, collectively, have not withdrawn from the role of resource allocator in the financial sector. Given the investment-driven nature of China's economy and the significant share of investment that is bank-financed, the decentralized government's continued role in the allocation of financial resources indicates that it exerts significant leverage over the allocation of resources in the economy as a whole. In particular, enterprises in the state-owned industrial sector have required significant capital merely to sustain operations. The continued presence of these enterprises that might have otherwise exited the market significantly distorts the operating environment for the private sector. Thus, not only does the banking sector fundamentally distort financial resources in China, it also distorts the allocation of other important resources, *e.g.*, labor, material inputs and energy that are wasted in economically unjustifiable investments.

As a general rule, resources do not flow to their best use, at the firm, industry or sector level; the underperforming SOE sector still accounts for a disproportionate share of bank lending and fixed asset investment and other resource allocations.

Factor Six. *Such other factors as the administering authority considers appropriate.*

Under this factor, the Department can address any additional issues relevant to its consideration of market economy status. A number of economic reform issues raised by the commentators do not readily fit into any of the preceding five factors, including trade liberalization and rule of law.

Trade liberalization

China was an original member of the 1947 General Agreement on Tariffs and Trade ("GATT") but withdrew in 1949, as it was no longer willing to honor tariff concessions and open trade obligations. China announced in 1986 that it would apply for access to the WTO under Article XII of the Marrakesh Agreement Establishing the WTO. After 15 years of multilateral and bilateral negotiations, China acceded to the WTO in 2001 under the terms of its Protocol of Accession, which includes all of the specific commitments in the Working Party Report.

China has entered into bilateral investment agreements with 108 countries, more than any other country at a similar stage of economic development, according to the UN Conference on Trade and Development.[378] Agreements have been signed with Japan, Germany, the United Kingdom, France, Italy, Thailand, Romania, Sweden, the Belgium-Luxembourg Economic Union, Finland, Norway, Spain, Austria, and others. The provisions of these agreements cover such issues as expropriation, arbitration, most-favored-nation treatment, and transfer or repatriation of proceeds.

Rule of Law

The legal principle of "rule of law," upon which transparency and predictability is based, provides that decisions should be made through the application of known principles or laws without the intervention of discretion in their application.[379] Implementing rule of law is a major challenge for nearly every transitional economy and requires, at core, a fundamental shift away from the mind set of "rule of man." Policy- and Lawmakers must accept predetermined limitations on their discretion; citizens must accept the obligations of personal responsibility; and, an independent judiciary enforces those limitations and obligations. In both theory and rhetoric, China has recognized the importance of making this leap. In practice, however, China has implemented a legal system that preserves privileged positions for the CCP and the state-owned sector.[380]

China's economic legal reforms have been characterized by a proliferation of legislation, regulations, orders, rules and explanatory circulars affecting the entire economic sphere -- private, state-owned and foreign-invested -- enacted on a largely reactive basis. This unwieldy and often contradictory body of law is buttressed by policy statements of government priorities and development objectives meant to guide the implementation of laws, but which also provide the basis for *ad-hoc* implementation based on the interpretation, discretion, and/or personal interests of the administering authority. As a result, China's economic operating environment is,

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[378] *Country Commercial Guide: China* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[379] Black's Law Dictionary.

[380] "There is no sign to indicate that the Chinese Communist Party is genuinely committed to building a modern legal system... The court system is controlled by the Chinese Communist Party and local governments...Party and government officials routinely interfere in court decisions...Because Chinese courts are really part of the state bureaucracy they typically lack the political authority to enforce their decisions. As a result court judgements cannot be enforced if they are resisted by local authorities." *See* Pei, Minxin, *Testimony on Rule of Law in China* (Washington, DC: Senate Foreign Relations Committee, June 7, 2005). "Notwithstanding the important changes in [China's] legal system observed in the last two decades, this institution model based on the leading role of the Communist Party has continued to thwart major and dramatic legal reforms." *See* Cabestan, Jean-Pierre, *The Political and Practical Obstacles to Reform of the Judiciary and Establishment of Rule of Law in China* (Journal of Chinese Political Science, Vol. 10 Issue 1, March 2005), p 45.

at best, unpredictable for private parties vis-à-vis other private parties;[381] disputes involving state interests are often predictably resolved in favor of the state.[382]

China faces a myriad of major challenges in overcoming its legacy of autocratic rule of man. As described above in factor five, China must implement a comprehensive legal system that fully respects and protects private property rights in a predictable manner. In this vein, the PRC government must promote and enforce corporate governance, shareholder rights and accounting standards that will protect private property rights and increase transparency, allowing the flow of information necessary to inform the market. Further, China must continue its reforms aimed at the protection of IPR.

China must also promote an independent judiciary, which is notoriously subordinate to government officials at all levels.[383] Businesses view discrimination in the local judiciary as a serious implication of local protectionism. For example, businesses find that local judiciaries are not as active when an "outside" enterprise brings a lawsuit against local enterprises nor as active when enforcing rulings against local enterprises.[384]

China must acknowledge and address corruption. Most of China's anti-corruption strategy has focused on curbing corruption within the government and has yet to address major issues with regard to corruption in the commercial sphere.[385] Beyond this, new forms of

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[381] *The Economist Intelligence Unit, Risk Briefing, China Risk: Legal and Regulatory Risk*, August 11, 2006.

[382] "Courts remain beholden to political leasers and are unable to take independent decisions based on objective consideration of laws and facts on a consistent basis. At the local level, judges are very unlikely to rule against local dignitaries, such as government and party officials and managers of state-owned enterprises." *Id.*

[383] "The main weakness in law enforcement is that the judiciary is insufficiently independent in a number of areas, as funding for and promotion of judges is determined locally, and the court are subordinated to the local people's congresses (Lo and Tian, 2005). As a result, court decisions can be biased in favor of parties in their own locality (Lie et al., 2004)." *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 94.

[384] *China: Integration of National Product and Factor Market* (Washington, DC: World Bank, June 13, 2005), p 17. *Economic Survey of China* (Paris, Organization of Economic Cooperation and Development, 2005), p 41 as well as p 94, stating that "(f)irms operating in regions with lower risk of government expropriation and more reliable contract enforcement tend to have higher rates of reinvestment, and therefore generate more rapid growth (Cull and Xu, 2004).

[385] In China, the penalty for giving a bribe could be a possible sanction or imprisonment; however, the penalty for accepting a bribe as a government employee is life in prison or the death penalty. The common belief is that those giving bribes had no choice but to do so and party officials choose to accept a bribe. *See Fighting Corruption in China* (Paris, Organization for Economic Cooperation and Development, 2005), p 111-112.

corruption have begun to supersede bribery as a major issue in Chinese business, including money laundering and accounting rules violations.[386]

Guanxi, the use of personal connections, is used extensively in China to circumvent law, gain leniency in the judicial system, gain access to resources, or gain entry through the "back door," *zou hou men*, to secure government approval.[387] The implementation of rule of law will require that all actors, from the government to citizens, shift their business methods from one based solely on personal relationships to one where rights are expected and respected, fulfilling obligations embodied in the governing laws.

ANALYSIS AND ASSESSMENT

Although section 771(18)(B) of the Act enumerates six factors that the Department must consider in determining a country's market economy status for purposes of the U.S. antidumping, the statute provides no direction or guidance with respect to the relative weight that should be placed on each factor in assessing the overall state of the economy. As discussed above in the "Analytical Approach" section, the Department considers whether the facts, as applied to the statutory factors, demonstrate that the economy is generally operating under market principles.

The Department recognizes the positive changes, both *de jure* and *de facto*, that China's economy has experienced in the past 25 years. The PRC government has undertaken significant reforms to promote the introduction of markets forces into the economy. However, in applying the factors required under section 771(18)(B) of the Act, we recognize that China has a dynamic (but constrained) private sector, but also find that the state retains for itself considerable levers of control over the economy.

China has resisted a definitive break with its command-economy past, opting instead to introduce some market mechanisms alongside government plans, and to shrink the role of the state in some areas while preserving it in others. Much as in earlier eras of China's development, from the household responsibility system to "keeping the large and letting go of the small," China continues to combine market processes with continued decentralized government control. In the process, China has reaped some of the efficiency gains of market processes without ceding fundamental control over the economy to market forces.

386 *Ibid*, p 105. In 2005 two branches of the CCB reported over 30 million yuan (3.6 million dollars) embezzled by the presidents of the branches. Similarly, the BoC reported that two employees fled the country after embezzling one billion yuan (120 million dollars). *CCB Removes Two Senior Leaders Amid Listing* (China Daily, May 30, 2005).

387 Zimmerman, James, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 2nd edition* (Chicago: American Bar Association, 2005), p 71.

For example, although the *renminbi* is convertible for current account purposes and an interbank FOREX market is beginning to take shape, the exchange rate remains insulated from market forces. Similarly, wages are no longer set by the government, but administrative measures, such as the *hukou* system and the lack of independent trade unions, limit the impact of market forces on wage formation.

China has been successful in attracting FDI, and has achieved this success through a combination of tax and other incentives, through its attractive position as an export manufacturing base, and by the promise of access to its vast domestic market. Foreign investment, while encouraged in some industries, is quite constrained in others. In a large but poorly defined set of industries deemed to be of national importance to the government, foreign investment is restricted or only allowed if deemed by the government to serve its development plans. While the overall picture on foreign investment is positive, it also shows that the government has not receded from its traditional role of directly managing China's economic development.

China has closed or privatized a large number of loss-making SOEs and collectives over the past ten years, and in doing so has created new avenues for private enterprise to develop in the economy. Some of the remaining SOEs, moreover, have benefitted from management reforms that have made them more efficient than in the past. Nonetheless, the PRC government's stated objective is to develop and sustain SOEs in "core" industrial sectors to ensure that they retain a key role in what the government refers to as a socialist market economy. Accordingly, while private enterprise can flourish in some parts of China's economy, it is relegated to a subordinate role in others. The PRC government maintains this privileged role for key SOEs through an institutional framework that varies by industry, and through the government's powerful influence over the allocation of resources in the economy.

Firms in industries that are dominated by the private sector also operate in a business environment distorted by state presence and the weakness – or absence – of the legal and institutional factors that underlie functioning markets, *e.g.*, rule of law and property rights, and meaningful bankruptcy laws. Moreover, there are no private land ownership rights in China.

The PRC government no longer allocates resources directly through budgetary outlays as in a traditional Soviet-style command economy. Instead, its primary levers of control lie in its use of administrative measures (which allow for *ad hoc* discretionary policy implementation) and decentralized control over the banking sector. Despite recent banking sector reforms, the government retains near complete ownership over the commercial banking sector. This has generated a continuing cycle of lending on a non-commercial basis, the accumulation of large number of non-performing loans, and government bailouts of the banking sector.

In conducting its analysis of China's status as an NME for purposes of the U.S. antidumping law, the Department has considered the totality of China's economic reforms. While China has enacted significant and sustained economic reforms, our conclusion, as stated in the May 15th memorandum, is that market forces in China are not yet sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's dumping analysis. The Department shall, therefore, continue to treat China as an NME for purposes of the U.S. antidumping law.

Signed

David M. Spooner
Assistant Secretary
for Import Administration

August 30, 2006

Date