

CHINA AND THE WTO: COMPLIANCE AND MONITORING

HEARING BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION ONE HUNDRED EIGHTH CONGRESS SECOND SESSION

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FEBRUARY 5, 2004
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The Commission's Statutory Mandate begins on page 176.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

MARCH 4, 2004

The Honorable TED STEVENS,
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT,
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our February 5, 2004 hearing on “*China and the WTO: Compliance and Monitoring*.”

China is not a fully developed market economy and was even less so at the time of its accession to the WTO. Integrating a large non-market economy into an international trading system that was designed for and dependent upon the efficient operations of markets posed a challenge of monumental proportions. To help meet this challenge, China’s accession agreement required it to implement changes to its laws and economic system that had generally been a prerequisite for entering members. WTO members accepted China into the organization only after negotiating the most complex accession agreement in WTO history, one that reflected a large number of commitments by China to transition to a market- and rules-based economy and special safeguards for the domestic industries of other WTO members that could be significantly injured by surges of imports from China’s non-market economy. Assuring that China implements these commitments is a large and important task for the U.S. Government.

The Commission held this hearing with the twin goals of assessing China’s progress in complying with its schedule of commitments and gauging the adequacy of U.S. Government monitoring processes. At our hearing, the Commission received the testimony of officials from the U.S. Trade Representative (USTR) and the Departments of Commerce, State, and Agriculture. A panel of legal experts compared the contemporary situation with China’s stated obligations and with U.S. expectations at the time of China’s accession. The Commission also heard from representatives of agriculture, business, industry and labor organizations, many of whose members have first-hand knowledge of China’s practical compliance.

China’s Compliance

China has made only mixed progress towards complying with its WTO obligations. For instance, China has generally completed a broad range of tariff reductions in accordance with timetables stipulated in the accession agreement. It has revised or enacted a large number of laws and regulations to bring its trade system into better conformity with WTO norms. In the services sector, it has reduced capitalization requirements for some financial services operations, but requirements remain higher than can be justified. After sustained pressure from U.S. officials, China reduced barriers to U.S. agriculture exports through reform of tariff-rate quota implementation. Despite these and other positive steps, China has on the whole fallen behind its schedule of commitments, and in some areas has implemented new barriers to trade to compensate for those it is removing.

Some of the most egregious gaps between commitments and current practices include: rampant abuse and lax protection of intellectual property rights, lack of transparency in adopting and applying regulations, the use of technical or safety standards to unreasonably exclude foreign products—including non-science-based sanitary and phytosanitary standards on agricultural products—implementation of discriminatory tax incentives to encourage U.S. and other foreign semiconductor companies to move their manufacturing operations to China, and obstacles to the domestic distribution of imported products.

The Commission finds that:

- China has made progress on WTO compliance in absolute terms, but this progress toward compliance has decelerated to an unacceptably slow pace. Furthermore, some lowered barriers to trade have been replaced by new barriers that deny market access to U.S. exports of goods and services, a practice that we categorically reject.

Enforcement

While the Commission is satisfied that the U.S. Government is competently monitoring China’s compliance, we question the enforcement effort to date. The U.S. has yet to file a single dispute against China in the WTO, despite numerous clear viola-

tions disclosed at our hearing. The Commission understands that something of a 'honeymoon' period was necessary for China to have the opportunity to implement its accession commitments and to afford the U.S. the time to review China's nascent track record. The two years that have passed since China's accession represent a period of sufficient length for such restraint and forbearance, a period which we now expect to come to a close.

The Commission also acknowledges the value of settling a potential dispute case through bilateral negotiations, which offer the promise of relief for afflicted U.S. industries on a compressed time scale. However, such negotiations will find greater success if accompanied by a history of determined use of the WTO dispute resolution mechanism when necessary. The Commission therefore urges continued bilateral discussions on the catalog of compliance gaps, but similarly advocates vigilant use of formal channels for redress when China fails to address grievances.

One area of monitoring we found to be particularly lacking is the WTO's Transitional Review Mechanism (TRM) for reviewing China's compliance. This annual review process was established as part of China's accession agreement to the WTO. U.S. negotiators expected the TRM to be a robust mechanism for monitoring China's WTO compliance and applying multilateral pressure for improvement. In practice, the TRM has been undermined by China's refusal to abide by standard WTO procedural methods such as responding in writing to requests for information from other member countries and its unwillingness to have TRM issues raised in WTO subsidiary committee meetings at a sufficiently early stage to have a meaningful dialogue on the concerns. China argues that the normal customs of the WTO do not apply because the TRM is a discriminatory measure applying only to China. The Commission notes that China's entry into the WTO was conditioned on China's acceptance of the TRM and other special provisions intended to compensate for the disjunction between WTO standards and China's non-market economy and underdeveloped legal system. China accepted and signed the WTO agreement that created and governs the TRM and therefore should desist from arguing that it is discriminatory and instead cooperate in making it a useful mechanism to improve its implementation of its WTO obligations.

The Commission finds that:

- The TRM has failed to live up to the expectations of the U.S. and other WTO members that it would be a comprehensive tool for measuring and evaluating China's compliance with the full range of its commitments and a robust mechanism for putting multilateral pressure on China to address compliance shortfalls.

U.S. Economic and National Security

The Commission believes that the Executive Branch is sufficiently monitoring China's compliance with WTO obligations, and providing its results to the Congress and the public at large in a timely manner. However, the Commission finds that too little attention has been paid to the security implications of China's participation in the WTO. American economic security rests on a broad foundation of economic activity, and actions to protect U.S. economic security will be bolstered by measures employed to compel China's compliance with its WTO obligations. Finally, the U.S. must take care to preserve its domestic industries whose health is directly related to important military capabilities.

Based on the record of this hearing and the Commission's other work on these issues to date, we present the following preliminary recommendations to the Congress for consideration. The Commission will continue to develop these recommendations and provide additional guidance in our annual Report to the Congress.

Preliminary Recommendations:

- The U.S. Government should signal clearly to China that its WTO 'honeymoon' period has ended, and that the U.S. will no longer hesitate to secure its rights through formal recourse to the WTO when necessary. Such a statement should accompany the first filing of a WTO case. The Congress should press the Administration to use the WTO dispute settlement mechanism and/or U.S. trade laws, including Section 301 provisions, to seek redress for China's practices in the areas of exchange rate manipulation, denial of trading and distribution rights, massive violations of intellectual property rights (IPR) that have cost U.S. firms billions of dollars, and government subsidies to export industries that harm the competitiveness of U.S.-based manufacturing firms.
- China's preferential value-added tax (VAT) treatment for domestically designed and produced semiconductors and other discriminatory policies are encouraging large foreign investments into semiconductor manufacturing facilities in China, leading to a global overcapacity in that industry that threatens U.S. producers. The Commission commends ongoing USTR efforts to resolve the issue expedi-

tiously through negotiations, but now recommends that the U.S. forthwith file a WTO case on the matter.

- China's WTO obligations for curbing the abuse of intellectual property rights demand not only China's promulgation of appropriate legislation or regulations, but also concrete results in the reduction of IPR violations, which are thus far lacking. The U.S. should offer China assistance in implementing a program to curb the abuse of IPR that includes criminal penalties against its citizens who engage in such WTO-required practices. This offer should be coupled with an explicit timeline for implementation and realization of results. The timeline should also guarantee filing of a WTO case if the offer is rebuffed or its implementation unsuccessful.
- The U.S. should put in place procedures for consulting with trading partners at the outset of each new dispute over China's compliance. Particular efforts should be made to work closely with the EU, Japan, and others to ensure that China lives up to its WTO commitments.
- USTR and other appropriate U.S. Government officials should undertake strenuous efforts to reform the TRM process into a meaningful multilateral review and measurement of China's compliance with its WTO commitments. If this is unsuccessful, the U.S. Government should initiate a parallel process with the EU, Japan, and other major trading partners to produce a unified annual report by which to measure and record China's progress toward compliance. This measurement and evaluation should be provided in detail to Congress as part of USTR's annual report on China's WTO compliance.
- The U.S. Government should make optimum use of the special Section 421 and textile safeguards negotiated as part of China's WTO accession agreement. These important safeguards were designed to prevent our domestic industries from being forced into bankruptcy by surges of Chinese exports. Although the International Trade Commission has recommended that Section 421 relief be granted on a number of occasions, they have yet to be approved by the Executive Branch. Testimony was presented to the Commission that the Chinese Government has hired U.S. law and government relation firms to lobby the Executive Branch to ensure that the special safeguards are not utilized. This puts private sector U.S. firms seeking implementation of the safeguards at a disadvantage and may have the effect of nullifying important safeguards Congress relied on in approving PNTR for China.
- The Congress should amend our countervailing duty laws to permit their usage in relation to non-market economies. For example, the Chinese Government makes non-market based loans to its state-owned enterprises, enabling them to export subsidized goods to the U.S. market that harm the competitiveness of U.S. manufacturers.
- The transfer of technology by U.S. investors in China where it is a WTO-inconsistent condition of doing business with Chinese partners under Part I, Section 7(3) of China's Accession Protocol remains an enduring security concern for the U.S. The Commission understands there has been some reduction of this practice, but condemns any remaining instances of it and asks U.S. companies to help maintain U.S. Government vigilance by reporting any continuing or future occurrences.

We hope that this hearing record and the Commission's above findings and recommendations will assist the Congress in assessing a complex but vital subject of U.S.-China economic relations. As always, we stand ready to present to any interested Committees or Members the Commission's research and analysis on this and any other subject contained in the Commission's mandate.

Sincerely,



Roger W. Robinson, Jr.
Chairman



C. Richard D'Amato
Vice Chairman

Note:

Commissioner Bryen dissented from the Commission's majority in submitting these preliminary recommendations.

CONTENTS

	Page
THURSDAY, FEBRUARY 5, 2004	
CHINA AND THE WTO: COMPLIANCE AND MONITORING	
Opening remarks of Chairman Roger W. Robinson, Jr.	1, 6
Opening statement	8
Opening remarks of Commissioner Patrick Mulloy, Hearing Co-Chair	8, 49
Opening statement	9
Opening remarks of Vice Chairman C. Richard D'Amato	5
Opening statement	5
CONGRESSIONAL PERSPECTIVES	
Statement of Byron L. Dorgan, a U.S. Senator from the State of North Dakota	1
PANEL I: ADMINISTRATION VIEWS	
Statement of James Jochum, Assistant Secretary, Department of Commerce ..	10
Prepared statement	12
Statement of Randall Schriver, Deputy Assistant Secretary, Department of State	17
Prepared statement	19
Statement of Charles Freeman, Deputy Assistant U.S. Trade Representa- tive	21
Prepared statement	24
Statement of Patricia R. Sheikh, FAS Deputy Administrator	28
Prepared statement	30
Panel I Discussion, Questions and Answers	32
PANEL II: CHINA'S COMPLIANCE RECORD	
Opening remarks of Commissioner Patrick Mulloy, Hearing Co-Chair	49
Statement of Terrance P. Stewart, Managing Partner, Stewart and Stewart Law Offices	49
Prepared statement	52
Statement of Robert Cassidy, Director, International Trade and Services, Collier Shannon Scott, LLC	57
Prepared statement	60
Panel II Discussion, Questions and Answers	65
AFTERNOON SESSION	
PANEL III: AGRICULTURE, LABOR AND BUSINESS VIEWS	
Opening remarks of Commissioner William A. Reinsch, Hearing Co-Chair	73
Opening statement	74
Statement of Robert Kapp, President, U.S.-China Business Council	75
Prepared statement	77
Statement of Richard Trumka, Secretary-Treasurer, AFL-CIO	97
Statement of Robert Vastine, President, Coalition of Service Industries	99
Prepared statement	101
Statement of Robert Carlson, Chairman of the Legislative and Trade Com- mittee, National Farmers Union	105
Prepared statement	107
Panel III Discussion, Questions and Answers	110

VIII

	Page
PANEL IV: INDUSTRY, TECHNOLOGY, INTELLECTUAL PROPERTY RIGHTS	
Statement of William Primosch, Director of International Business Policy, National Association of Manufacturers	126
Prepared statement	128
Statement of Eric Smith, President, International Intellectual Property Alli- ance	133
Prepared statement	135
Statement of Anne Craib, Director of International Trade and Government Affairs, Semiconductor Industry Association	140
Prepared statement	143
Statement of Ann Wroblewski, International Vice President, American Forest and Paper Association	146
Prepared statement	148
Panel IV Discussion, Questions and Answers	152
ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD	
Statement of Timothy P. Trainer, President, International AntiCounterfeiting Coalition, Inc	163
Statement of Brad Smith, Managing Director for International Relations, American Council of Life Insurers	170

CHINA AND THE WTO: COMPLIANCE AND MONITORING

THURSDAY, FEBRUARY 5, 2004

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room HL-1310, Longworth House Office Building, Washington, D.C. at 10:04 a.m., Commissioners Patrick A. Mulloy and William A. Reinsch (Hearing Co-Chairs), presiding.

OPENING REMARKS OF CHAIRMAN ROGER W. ROBINSON, JR.

Chairman ROBINSON. If we might come to order, please. Thank you for being with us today, Senator.

I'd like to begin today's proceedings by first thanking Chairman Ney and Congressman Larson for use of this room on a day that required some reshuffling, as all of you know. We are delighted that Senator Dorgan could be with us to kick off this important session on World Trade Organization compliance and other related matters.

The co-chairmen for today's hearing will be Commissioners Patrick Mulloy and William Reinsch. As I understand it, Co-Chairman Mulloy will be conducting the morning hearings, and I'd like to turn to him now if I might to introduce Senator Dorgan.

Co-Chair MULLOY. I want to welcome everyone to this morning's hearing on China's compliance with its WTO obligations. I particularly want to welcome Senator Byron Dorgan of North Dakota, who is a good friend of this Commission and a supporter.

As a Senator from a state that is a major producer and exporter of agricultural products and one with many farmers concerned about full implementation of our trade agreements, he is well placed to speak about our trade relations with China.

With that said, I will save the rest of my opening statement until after the Senator's testimony, and Senator, we very much appreciate you being with us here today.

STATEMENT OF BYRON L. DORGAN A U.S. SENATOR FROM THE STATE OF NORTH DAKOTA

Senator DORGAN. Commissioner Mulloy, thank you very much, and I thank all of you for inviting me.

First of all, this is a very important topic, and I really appreciate the work of the Commission. I think that the issue of trade and economic security is very important. Our trade relationship with China is particularly important. We negotiated and effected a bilateral trade agreement with China in the year 2000, and I think it's important to try to take a look at what has happened since and

what the Chinese have done to comply with the bilateral agreement.

Will Rogers once said that the United States of America has never lost a war and never won a conference. He surely must have been thinking of our trade negotiations. With due respect to the negotiators, over a long period of time, we have consistently created what I think are fundamentally unsound and bad trade agreements, and more importantly, despite the deficiencies in the agreements themselves, we have had a miserable record of enforcing any agreement at any time with any country.

And so I think countries begin to understand that they can promise almost anything in a trade agreement, and in some cases, the record shows we can't even locate the agreement to determine whether there's an enforcement mechanism or a requirement for another country to comply with particular provisions. We have trade agreements with Japan, for example, that were inaccessible to those who wanted to see them because they couldn't be located, which suggests that there's no enforcement initiative at all.

And especially if you take a look at the amount of money the Congress and the Executive Branch devote to enforcement both at USTR and also at the Department of Commerce, it is a miserably small amount of money. Even if we had the will, which we do not have, to enforce trade agreements, the level of funding would not allow us to aggressively enforce agreements.

Having said all of that, let me discuss just for a moment the situation with China. All of us know that we have the largest trade deficit in human history, and we are not moving in the right direction; we are moving in the wrong direction, and it is a problem for this country. Nobody talks much about it. People want to ignore it and say that it's a function of our budget deficit, when we had budget deficits. Then when we had surplus, it was a function of currency fluctuations, and the reason changes from season to season.

But we have had abiding, long-term deficits with Japan, for example; now, with China we have an exploding deficit. Last year, the merchandise trade deficit with China was \$103 billion. It is expected to be somewhere above \$130 billion. I recall sitting in this building many years ago as a Member of the Ways and Means Committee debating with my colleague Congressman Gibbons over a trade relationship with China that at that point had a deficit of \$12 billion. It has, of course just radically exploded over more recent years.

But in January of 2000, our trade negotiators completed a bilateral deal with China, and let me describe specifically the issue of wheat.

On the matter of wheat, which is a matter of vital importance to my state, which is why I picked that particular issue, the Chinese, in the 2000 bilateral, indicated that they would create an 8.5 million tonne TRQ with the expectation that we would have significant access to the Chinese wheat market.

But almost immediately following that, I was alerted to something that was in the South China Morning Post, and the Vice-Minister for Agriculture Long Yong Tu went down to Quanzhou in south China, and he was quoted in their newspapers as saying—

in China now—don't worry about the agreement we have with the United States. Sure, we agreed to let in 8.5 million metric tonnes under this TRQ, but that doesn't mean that we are actually going to buy it. That's just theoretical.

Now that's what they said in China. So I busily wrote a letter to the Agriculture Minister in China. I wrote to Vice-Minister Long about it. I wrote to Ambassador Barshefsky about it. I actually did not hear back from either. But you know that what has happened since that time confirms what the Vice-Minister said in the South China Morning Post: they didn't intend to buy that quantity of wheat from the United States.

We have had great difficulty accessing their market. Why? Because the Chinese government, in the aftermath of this trade agreement, still has a stranglehold on import licenses necessary to purchase U.S. wheat. It's very simple. The Chinese government retains 90 percent of all wheat import licenses for state trading enterprises. They determine whether they buy wheat and from whom. They determine that.

And that's within the construct of our agreement with them, which doesn't make much sense to me. The Government of China gives private importers only about 10 percent of the wheat import licenses, and it's quite clear to me that the Chinese government, despite some urgings recently, doesn't really intend to comply with what we expected would happen from the bilateral agreement, especially with the subject of wheat.

Now, there was an announcement recently that the Chinese would buy 1 million metric tonnes of wheat over a 2-year period. Well, they had agreed to import 8.5 million metric tonnes a year, which this year was scheduled to go to 9.3 metric tonnes, and now they say 1 million metric tonnes over 2 years. That's a half a million a year; it doesn't represent compliance. Is it moving in the right direction? Sure, it's a baby step in the right direction. Does it satisfy me? Absolutely not.

This trade deficit with China is growing. It is dangerous, and this country needs to take notice of it and decide to enforce its bilateral agreements with countries like China aggressively. China decides as a matter of their strategy, because they've seen Japan and others do it successfully, that they will soak our marketplace with their trousers, their shirts, their trinkets, their toys, and our marketplace accepts them all. And then, when it comes time for us wanting to enter the Chinese marketplace, it is not quite so easy.

In my judgment, that is not the way reciprocal trade should be. And let me give you an example. There are reports, and I think they are accurate reports that an interagency task force in this Administration had a recommendation made to it that action should be taken with respect to the Chinese on the issue of wheat. But the State Department decided not to do that, because that would upset the Chinese. It's a simple explanation, but it's what exactly happened.

And I wrote letters to all the folks who were on the interagency task force to try to get confirmation of exactly who did what, and of course, it all becomes very murky. But what it describes to me once again is that most of our trade policy is foreign policy. For the first 25 years after the Second World War, virtually all of our trade

policy was simply foreign policy. And that was all right, because we could beat anybody with one hand tied behind our back.

Now, of course, we have tough, shrewd, international economic competitors, and our trade policy ought not any longer be foreign policy; it ought to be hard-nosed economic policy relating to competition between our country and other countries for international trade.

The China issue is perhaps more important than other issues because with China we have the single largest trade deficit. And as a result, we have to focus on that, but I must say that our country has a responsibility to go well beyond that. We have abiding difficult trade problems and significant deficits with Japan, with Europe, with Canada and Mexico, so we would be well advised to go well beyond the China issue.

But this Commission is a Commission to evaluate what has happened since the 2000 bilateral agreement. The one breath of fresh air is that we never really do this. We just make an agreement, and then we rush off to see if we can negotiate the next one without looking back. This rear view mirror opportunity with this Commission is very important. I hope your recommendations are aggressive and that you will be aggressive with the Congress on this issue so that we can, in Congress, begin to take the steps that are necessary to bring our trade policies back into line.

If I might, I have taken a little more time than I intended, but if I might make one more comment, what I have just told you with respect to these issues is almost always interpreted by some as statements. The minute you say anything of the type I've said, you're a protectionist. You want to build walls around this country. You are some kind of isolationist, xenophobic stooge who just doesn't get it. The thinkers get it, but we don't get it.

That is nonsense. This country's economic interest is best served by trade pacts that are mutually beneficial. And when they are not mutually beneficial, then we, as a country, have a responsibility to take steps to represent our interests, and we ought not to be embarrassed or ashamed or in any way. We ought not shy from that responsibility. That is, in fact, our responsibility.

So let me thank you for the work you're doing. I know that you're hearing from USTR today. I hope that you will have aggressive, sharp questions. My hope is that your work will contribute to the efforts of those of us in Congress who want a trade policy that represents our interests with respect to jobs and economic opportunity and expansion.

One final point: the world has become globalized. I don't deny that; I accept that; I understand that. But the rules for globalization have not kept up with the galloping pace of globalization, and we must, with respect to China and other countries, decide what those rules are. Should a 12-year-old making 12 cents an hour working 12 hours a day be producing products to be shipped to Cleveland and to Toledo and to Fargo and to Los Angeles? Is that fair competition with an American worker in an American business? We have not confronted those rules, and we must in my judgment, in order to retain a strong, vibrant manufacturing base in this country.

Mr. Chairman, thank you for hearing me.

Chairman ROBINSON. Thank you very much for your important words. I am certainly glad that you laid down markers in advance of today's important hearing. And we very much appreciate you taking the time to be with us.

Mr. Vice-Chairman, now?

OPENING REMARKS OF VICE CHAIRMAN C. RICHARD D'AMATO

Vice Chairman D'AMATO. Thank you, Mr. Chairman. And Senator Dorgan, thank you very much for testifying before us this morning. You have been a leader not only on China trade but also on the deficit matter itself. You were the creator of the commission that preceded this one, the Trade Deficit Review Commission. You were one of the co-sponsors of the amendment that established the China Commission on the Senate floor. I just want to assure you that we are going to be calling the shots exactly as we see them and as aggressively as it appears to us.

I might point out that the Commission visited the WTO last month in Geneva, and your comments about the miserable nature of enforcing that agreement pertain to that. We have been pretty bad at that, but we are matched by our partners in Geneva in this miserable record of enforcement. If we're going to get the Chinese to do something about complying with their agreements, we are going to have to be much more forceful in Geneva on the WTO compliance matter. That's very clear.

So thank you very much for your leadership on this issue.

Co-Chair MULLOY. Thank you, Senator Dorgan, for your help and for being such a good supporter of this Commission, and we will try to really look at the stuff and come up with some good recommendations. Thank you again.

[The statement follows:]

Opening Statement by Vice Chairman C. Richard D'Amato

I thank Chairman Robinson and the co-Chairs of this hearing for putting together an excellent agenda, and appreciate Senator Dorgan's support and guidance.

I would like to add just a few words about the purpose of this hearing. It is important that our Government do all it can to ensure that China is living up to its end of the WTO bargain. The whole point of granting China Permanent Normal Trade Relations status back in the year 2000 was so that the U.S. could conduct its trade relations with China through the WTO. Among other things, the WTO offered us a venue for dispute resolution. Furthermore, in its WTO accession agreement China was obliged to accept certain special provisions—such as the Transitional Review Mechanism and special safeguards on import surges and textiles—that were key conditions for our country to be able to sign the deal.

We need to know how these and other aspects of China's accession agreement are working. We need to keep track of whether the promised opportunities afforded by China's entry into the WTO have been realized by American exporters and producers of agricultural and industrial products and the providers of services in our high-tech, information-intensive service economy. If in fact Chinese import barriers have been lowered by adherence to WTO norms, our exporters ought to be seeing the benefits now.

There is now enough of a track record to give us a picture of where China is doing well and where it is not; and where our companies and workers and farmers are benefiting—or not. We as a Government need to determine—and this Commission wants to know, as it advises the Congress—whether, after two years of phased-in commitments, there are things China is doing that are WTO-inconsistent and need to be challenged in the Geneva dispute settlement process or under American trade laws. As we heard in Columbia, South Carolina last week, the enforcement of our trade laws is a high priority for several Members of Congress, including Senator Hollings, who spoke eloquently on the subject and previewed for us his plan to introduce legislation in this regard.

I am surprised that no country yet has brought a dispute settlement case against China in the WTO. Certainly it is not for lack of compliance concerns. For the U.S., ripe cases might include such actions as: direct subsidies to exporters, discriminatory import licensing procedures, or continuing to give Value-Added Tax rebates to domestically-manufactured products but not to imports. It appears that other members of the WTO are waiting for the U.S. to break the ice, and we should do so soon to ensure that the WTO is the hoped-for robust forum for enforcing China's trade commitments.

We look forward to hearing from our expert panelists on these and other questions that are key to the health of the U.S. economy and to the U.S.-China relationship.

OPENING REMARKS OF CHAIRMAN ROGER W. ROBINSON

Chairman ROBINSON. At this time, I would like to begin formally our hearing today. Welcome to the U.S. China Economic and Security Review Commission's sixth public hearing of the 108th Congress. Our topic today is China's compliance with its obligations as a member of the World Trade Organization and the U.S. Government's monitoring and enforcement efforts regarding same.

The co-chairs, as I've mentioned, for today's hearings are Commissioners Patrick Mulloy and William Reinsch, who will describe today's proceedings in greater detail shortly, introduce panelists, and I'm confident keep the discussion disciplined and focused.

Today's hearing follows a very productive yet I must say sobering field investigation that several Commissioners conducted last Friday in Columbia, South Carolina to look at China's impact on the U.S. manufacturing base. At that event, Senators Hollings and Graham spoke forcefully about the need for the U.S. Congress and the Administration to address the challenges China is posing for our manufacturing sector.

Their comments reflected what I think is the growing bipartisan concern in the Congress over trade-related economic dislocations occurring in our economy. As a Commission tasked with assessing both the economic and security dimensions of our relationship with China, this is indeed a key area for our deliberations.

In South Carolina, we heard first hand about the problems faced by the textile, steel and plastics industries and the impact on workers, businesses and local communities. That dialogue really put into sharp relief many of the questions we consider here rather routinely in Washington. The testimony we heard one after another from various manufacturing sectors was troubling and requires urgent action.

Today, we will be focusing on the broader issue of the promise and reality of China's two years as a member of the WTO. To what extent has it led to expanded export opportunities for U.S. goods and services? To what extent has it exacerbated imbalances in our trade relationship? To answer both questions, it is imperative that we understand as an initial matter how well China has been adhering to its far-ranging commitments to the WTO and how well the U.S. and WTO have been monitoring and enforcing compliance.

I should note that tomorrow, the Commission will be holding a hearing on the subjects of China's military modernization and the cross-strait military balance, a very timely topic, I think most of you would agree, given current tensions between China and Taiwan in the run-up to the Taiwan Presidential election next month.

Taken together, today's and tomorrow's hearings illustrate the broad set of inquiries our Commission is undertaking to gain a more holistic understanding of the U.S.-China relationship.

I would like to turn to our Vice-Chairman at this time, Dick D'Amato, for his opening statement.

Vice Chairman D'AMATO. Thank you very much, Mr. Chairman.

I want to welcome our panelists today. I just have some brief remarks. If the United States is going to be successful in bringing China into compliance with its WTO obligations, it is increasingly obvious that we are going to have to consider seriously bringing some cases against China in that organization for dispute resolution. No other countries will do it. That is very clear to us, since it was clear to us in our meetings with representatives of those countries that they feared Chinese retaliation against their businesses if they do it.

So if we don't take action very soon, the Chinese will not take their obligations as seriously as they should within that organization. It is important that the United States do all it can do to ensure that China lives up to its end of its WTO bargains. The U.S. and other members of WTO bent over backwards to accommodate China's admission to the WTO, even though China was not ready, of course, because of her lack of a market based system.

So we negotiated over the years and allowed China in but required a series of promises of performance in a variety of vital trading areas. China has taken the position, as was told to our delegation in Geneva by the Chinese ambassador to the WTO that, quote, she should not have signed those concessions, unquote. Perhaps not, but she did sign them, and we would not have approved her entry had she not.

Now, China claims that the concessions are discriminatory against her. China cannot have her cake and eat it, too. Either she abides by her promises, or we initiate, and soon, a series of important cases to either bring China into compliance or penalize her for renegeing on her promises.

There is now enough of a track record to give us a picture of where China is doing well and where it is not, whether our companies and workers and farmers are benefiting or not. In its WTO accession agreement, China was obliged to accept certain special provisions, such as the transitional review mechanisms and special safeguards on import surges in textiles.

U.S. companies and their associations such as the Chamber of Commerce and the National Association of Manufacturers have given this Commission extensive detail on what they regard as WTO inconsistent behavior by China. As we heard in Columbia, South Carolina last week, the enforcement of our trade laws is a high priority for Members of the Congress. As Senator Hollings and Senator Graham made clear in very eloquent testimony to the Commission, this is not a theoretical exercise. As the manufacturing base of our country is at stake and in fact is the state of our service industries and high technology sectors as well.

Jobs are at risk by the tens of thousands per month in this country currently. So we look forward to hearing from our witnesses on these important matters today.

Thank you, Mr. Chairman.

[The statement follows:]

Opening Statement by Chairman Roger W. Robinson, Jr.

Good morning. Welcome to the U.S.-China Economic & Security Review Commission's sixth public hearing of the 108th Congress. Our topic today is China's compliance with its obligations as a member of the World Trade Organization and the U.S. Government's monitoring and enforcement efforts in this regard. The co-chairs for this hearing are Commissioners Patrick Mulloy and William Reinsch, who will describe today's proceedings in greater detail, introduce panelists, and keep the discussion disciplined and focused.

Today's hearing follows a very productive yet sobering field investigation that several Commissioners conducted last Friday in Columbia, South Carolina, to look at China's impact on the U.S. manufacturing base. At that event, Senators Hollings and Graham spoke forcefully about the need for the U.S. Congress and Administration to address the challenges China is posing for our manufacturing sector. Their comments reflected the growing bipartisan concern in the Congress over the trade-related economic dislocations occurring in the U.S. economy. As a Commission tasked with assessing both the economic and security dimensions of our relationship with China, this is a key area for our deliberations.

In South Carolina we heard first hand about the problems faced by the textile, steel, and plastics industries and the impact on workers, businesses, and local communities. The dialogue that took place put the questions we study here in Washington into sharp relief. The testimony we heard, one after the other, from various manufacturing sectors was troubling and requires urgent action. Today we will be focusing on the broader issue of the promise and reality of China's first two years as a member of the WTO. To what extent has it led to expanded export opportunities for U.S. goods and services? To what extent has it exacerbated imbalances in the trade relationship? To answer both questions it is imperative that we understand as an initial matter how well China has been adhering to its far-ranging commitments to the WTO and how well the U.S. and the WTO have been monitoring and enforcing compliance.

I should note that tomorrow the Commission will be holding a hearing on the subject of China's military modernization and the cross-Strait military balance, a very timely topic given current tensions between China and Taiwan in the run-up to the Taiwan presidential election next month. Taken together, today's and tomorrow's hearing illustrate the broad set of inquiries our Commission is undertaking to gain a more holistic understanding of the U.S.-China relationship.

OPENING REMARKS OF CO-CHAIR PATRICK MULLOY

Co-Chair MULLOY. If our witnesses could come up to the table, it would be great.

Well, first off, thank you very much for being with us. This Commission was created by Congress precisely to look at the U.S.-China trade and economic relationship. This hearing is prompted a specific charge from the Congress to, quote, "review China's record of compliance to date with its accession agreement to the WTO and to explore what incentives and policy initiatives should be pursued to promote further compliance by China."

That is the purpose of today's hearing, to fulfill a charge given to this Commission by Congress. We are very fortunate to have with us on our first panel four key Administration officials who are involved in holding China to its WTO commitments and to fashioning U.S. trade policy toward China. They are Assistant Secretary of Commerce James Jochum, who spent many years on Capitol Hill and is very familiar with how the Congress thinks about these issues, and we're very happy, Mr. Jochum, that you are in that position.

We also have with us the Deputy Assistant U.S. Trade Representative Charles Freeman, and again, Charles, I know you spent time on the Hill and understand the political interest in this particular issue.

We are also fortunate to have with us Deputy Assistant Secretary of State Randall Schriver, and thank you for being with us, and finally, our Deputy Administrator of the Foreign Agricultural Service, Patricia Sheikh, and thank you, Patricia, for being with us.

In a later panel today, we are going to hear from Mr. Terry Stewart, who is doing work for this Commission. He is one of top trade lawyers in Washington and has analyzed China's WTO obligations and will look at how they are complying with them. And on that same panel, we're going to have Mr. Cassidy, who was formerly in USTR and helped negotiate this agreement with China, and now, he is outside the system, and he is looking at it and will help us to evaluate it from his perspective of what we bargained for and what we are getting.

There is one last point that I think is very important for people to understand. The reason this is so important is that China did not—the people who were in the GATT and now the WTO system are supposed to have market-based economies. China did not have a market-based economy but came into the WTO on the basis that it would implement a whole series of steps comply with its obligations.

Since China does not have a market-based economy, it's more difficult to get our exporters access to its market, obviously, and so, that's why this is so important, to follow what is going on with China and how this is being implemented. And another reason it's so important is because there is now this massive trade deficit with China, which makes this a political issue in the United States.

So thank you very much for being with us. Mr. Jochum, if you could start, and we'll just move across from left to right.

[The statement follows:]

Opening Statement by Hearing Co-Chair Patrick Mulloy

Welcome to the morning session of our hearing on China's compliance with its WTO obligations. I will preside over the proceedings this morning. The other co-chair of this hearing, Commissioner Bill Reinsch, will take over the gavel this afternoon.

We especially welcome Senator Byron Dorgan of North Dakota, who in a moment will share with us his thoughts on today's topic. As a Senator from a state that is a major producer and exporter of agricultural products, one with many farmers concerned about full implementation of our trade agreements, he is well-placed to speak about our trade relations with China.

Let me review the purpose of today's hearing. China's accession to the World Trade Organization on December 11, 2001, was the culmination of more than ten years of negotiations that allowed China into the WTO only on the basis of a complex set of phased-in commitments. At the time of accession China's economic and legal systems did not conform to WTO standards. It is thus critical for the U.S. and other WTO members to monitor China's implementation of its clear commitments to lower import barriers and to revamp its foreign trade rules and practices—to make them more transparent, uniform, predictable and fair.

This Commission, which was established in the year 2000, has a mandate from Congress, among other things, to:

“review China's record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China”

Today we have four groups of panelists to help us fulfill this mandate. This is the first hearing we have devoted to this topic since January 18, 2002, which was just a month after China's formal accession to the World Trade Organization. At that time, and in our annual report published in July 2002, we considered mainly the nature of the commitments China had made. With a two-year track record of China in the WTO, now is a good time for this Commission to look at China's compliance

with those commitments and to assess how well the U.S. Government is monitoring and enforcing China's implementation of its WTO obligations.

In our opening panel we will hear from four key Administration officials who are involved in holding China to its WTO commitments and fashioning U.S. trade policy towards China. They are: Assistant Secretary of Commerce James Jochum, Deputy U.S. Trade Representative Charles Freeman, Deputy Administrator of the Foreign Agricultural Service Patricia Sheikh, and Deputy Assistant Secretary of State Randall Schriver.

Then we will hear from two experts in trade law, Mr. Terry Stewart and Mr. Bob Cassidy, to give us their views on how well China has met its obligations in its first two years of WTO membership. They both have a comprehensive understanding of what China committed to in its WTO accession agreement. Mr. Stewart, a distinguished trade lawyer, has done, on contract to this Commission, a major study of China's WTO commitments. Formerly an Assistant U.S. Trade Representative, Mr. Cassidy was involved directly with the U.S.-China bilateral negotiations on China's entry into the WTO. He can give us his views on how the agreement he helped negotiate has turned out in practice.

This afternoon we will hear from two panels representing a wide range of perspectives: agriculture, business, labor, services, manufacturing, and producers of intellectual property, semiconductors, and forest products. Commissioner Reinsch will introduce those panels in greater detail.

Today's hearing should help enlighten the Commission on where things stand on the challenges and opportunities presented by China's WTO membership and what potential initiatives the U.S. Government should pursue to improve any shortcomings. I welcome all the panelists and thank them for their participation.

PANEL I: ADMINISTRATION VIEWS

STATEMENT OF JAMES JOCHUM ASSISTANT SECRETARY, DEPARTMENT OF COMMERCE

Mr. JOCHUM. Thank you, Mr. Chairman, Members of the Commission, for inviting me to discuss the Commerce Department's role in monitoring China's participation as a member of the World Trade Organization. I would also say thank you for having me back. I think I testified about two years ago this time on non-proliferation issues. I have changed jobs, but hopefully, I know a little bit about both topics, and I am happy to be back before the Commission.

To highlight the importance of this issue, I would begin by noting that our bilateral merchandise trade with China likely exceeded \$170 billion in 2003, making China our third-largest trading partner. We don't yet have the official numbers from December, so that is why we are hedging a bit on the numbers. And although our imports from China are currently at a level of five times that of our exports, U.S. exports to China did reach a monthly record of \$3.3 billion in November of 2003, and many expect that the December numbers will equal or surpass that record.

So China is becoming an increasingly important market for American exporters, be they manufacturers, farmers or service providers. These gains are encouraging and directly result from China's accession to the World Trade Organization in December 2001.

The situation facing U.S. producers from a competitive perspective was far worse prior to China's entry into the WTO. At that point, our exporters lacked access to the Chinese market, but Chinese producers had relatively free access to ours. Today, by virtue of the WTO, Chinese tariff rates have declined, and American goods move more freely through the Chinese economy.

But there is still a very, very long way to go, which goes to the heart of the complaint many have about China. In our discussions at the Commerce Department with U.S. industry, we have identi-

fied four specific areas of concern to the areas of noncompliance that will be addressed by my colleagues. Without progress in these areas, China's efforts to implement its commitments will be less meaningful to U.S. companies.

The first area of concern is protection of intellectual property rights. While China has put in place the legal framework to protect intellectual property, it lacks an effective enforcement system, and ensuring effective IPR enforcement is critical to American companies doing business in China.

The second area where progress must be made is increased transparency. The lack of regulatory transparency in China continues to make for an unpredictable environment for American companies doing business in China.

The third area for improvement is standard setting. Although China is adopting more international standards, the continued use of homegrown standards in some areas has the potential to act as a market barrier to U.S. exports.

The final area of concern is ensuring nondiscrimination or national treatment for U.S. products and services. Whether it is through discriminatory Value Added Tax policies or through protectionist industrial policies, China's actions continue to raise concerns.

Notwithstanding these unresolved issues, we still believe China's leadership is earnest about its country's transformation to a market-based economy and has made progress to implementing its WTO commitments. But we must remain vigilant. The Department of Commerce, in close coordination with USTR and other agencies represented here, has adopted an aggressive and multi-pronged approach to ensure that China honors its WTO commitments and that U.S. companies benefit from these opportunities.

At the direction of Secretary Evans, the Commerce Department has devoted significant resources to monitoring China's progress and adhering to its WTO commitments. Specifically, each unit of the International Trade Administration plays a critical role in this process. For example, the Foreign Commercial Service maintains five offices—I'm sorry, offices in five cities on the mainland of China plus Hong Kong, which represents our largest presence of commercial officers in any single country throughout the world.

ITA's Market Access and Compliance houses an office solely dedicated to monitoring China with respect to its WTO commitments. At Import Administration, which is the agency I head up, we have in place an ongoing monitoring program that tracks import trends as well as certain government policies, business conditions and company practices regarding China.

Both MAC and IA rely on officers deployed in China on a full-time basis to gather information and track policy changes. While the Department will continue its focus on China's compliance activities, we must also enhance the ability of U.S. businesses to compete in China. To that end, the information and expertise that we gain through participation and cooperative programs with the Chinese is shared with U.S. businesses here at home. Last year, for example, ITA initiated its "Doing Business in China" seminar that will again be presented in cities across the country this year. These

seminars are designed to assist U.S. companies in gaining the tools to be competitive in the China market.

Finally, we are not only identifying areas in which China can change—we are also changing ourselves. For the first time in 20 years, plans have begun to implement an ITA reorganization that will equip us to more effectively meet the needs of U.S. industry and create a fair playing field for U.S. businesses trading with China.

Commerce plans to consolidate its export promotion services within the Department under a new assistant secretary for trade promotion. Funds have been allocated under this office to create a China Business Information Trading Center and several American trading centers to be established in major commercial centers around China.

We expect that these changes will allow us to promote U.S. imports more aggressively within China and actively engage the Chinese on issues that matter most to U.S. companies.

Within Import Administration, we are creating a new Unfair Trade Practices Task Force, a unit designed to strengthen ITA's ability to advance U.S. trade policies and negotiations and address the root causes of unfair trade. With respect to China, the task force has begun tracking imports in 30 key sectors in order to identify unfair trade practices. We will begin consulting with industry representatives to determine specific actions can be taken in other sectors as well.

Finally, Import Administration is in the process of creating China Enforcement Office that will focus on antidumping cases brought by U.S. producers injured by Chinese imports. Imports from China represent a rapidly growing source of trade complaints by U.S. industry and an increasing percentage of our practice at IA.

This new office will further cultivate the expertise necessary to address the unique problems encountered in the Chinese economy and will review current policies and practices to ensure that our trade laws work to the benefit of U.S. industry.

Based on all of these activities, I can assure you that the Department of Commerce is dedicated to making sure China plays by the rules that it agreed to upon entering the WTO and that American companies will be poised to take advantage of a more level playing field between the U.S. and China. We have already seen great progress in the form of record levels of U.S. exports to China. But much work is still to be done, and the tools we are putting in place will help us accomplish the goal of fully integrating China into a rules-based trading system.

Thank you again to the Commission for your support of our efforts and inviting me to speak today, and I look forward to your questions.

Co-Chair MULLOY. Thank you, Mr. Jochum.

Each witness is going to speak for no more than seven minutes, but your full statements will be put into the record. After the whole panel is completed, then, each Commissioner will have a five-minute questioning period.

So, thank you. Mr. Schriver?

[The statement follows:]

**Prepared Statement of James J. Jochum
Assistant Secretary of Commerce for Import Administration**

Thank you Chairman Robinson, Vice Chairman D'Amato, and Members of the Commission for inviting me to discuss the Commerce Department's role in helping ensure that China fully complies with its WTO obligations. I appreciate your dedication to this issue, and I further appreciate your giving me the opportunity to discuss the Department's efforts in this regard.

For both President Bush and Secretary Evans, the importance of trade extends well beyond the economic realm. As the President stated: "Open trade is not just an economic opportunity, it is a moral imperative. When we negotiate for open markets, we are providing new hope and promoting political freedom."

Economic and social imperatives associated with trade are the reason that the Administration has moved aggressively in pursuing an ambitious trade agenda. We will continue to move forward to expand our trade and the economic opportunities that it creates for all Americans, and to eliminate barriers to the free flow of all goods, services, investment and ideas.

This Administration understands that an aggressive trade liberalizing agenda must be accompanied by the strict enforcement of our trade laws. We understand the value of competition, and that it leads to innovation, growth, and a higher standard of living. But some of our trading partners have failed to embrace fair competition fully. Therefore, as we continue to encourage the opening of markets in countries such as China, we expect our trading partners to adhere to their international commitments. We will also work to identify areas where those commitments are not being met and will hold our trading partners accountable for resolving these short-comings.

At today's hearing I would like to take the opportunity to give an overview of the Commerce Department's role in monitoring one of the world's fastest growing economies and its participation as a member of the World Trade Organization. I will also highlight the importance of our trading relationship with China and actions the Department is taking to enhance this relationship.

Trade Relationship with China

Last year, as part of the Administration's Manufacturing Initiative, senior Commerce officials, including Secretary Evans and Under Secretary Aldonas, participated in more than 20 roundtables with manufacturers across the country. No single topic garnered more attention than our trade relationship with China. The stakes involved are high. While final trade statistics for 2003 have not yet been released, on an annual basis, bilateral trade merchandise reached \$179.2 billion in 2003, making China our third largest trading partner, and our second largest source of imports.¹ Last year, China surpassed Mexico to become our second largest source of imports. Our imports from China are more than five times greater than our exports. The bilateral trade deficit hit \$124.5 billion in 2003.² More positively, U.S. exports to China in November 2003 reached a record \$3.3 billion.

It is important to note, however, that a large share of what we now import from China used to be imported from other Asian countries. Because China's current role in the restructuring of global manufacturing is that of the final assembly point for most Asian electronic equipment destined for the United States, China becomes the country of origin for what before would have been an export to the United States from other Asian countries. In other words, it may be more appropriate to look at our trade account with China as an indicator of competition in manufacturing across Asia, as opposed to the rise of Chinese manufacturing alone.

There is an obvious upside to China's growth and the benefit the Chinese derive as investment in Asia shifts toward China, as well. That shift, together with China's economic policies, has brought about a rising standard of living in China and a considerable rise in disposable income for the average Chinese—in turn creating a consumer demand that did not previously exist in China. This consumer demand means an expanding market for goods and services, many exported from or provided by the United States, as opposed to the largely one-way street of the past. The fact that China's trade is nearly in balance overall, even though it runs a huge surplus with the United States, reinforces the link between a rising consumer demand and growth in imports.

¹ Bilateral merchandise trade data is annualized based on January through November 2003 actual data of \$164.3 billion.

² Bilateral trade deficit is annualized based on January through November 2003 actual data of \$114.1 billion.

All of this makes China an attractive market for much of what we produce in the United States, including for our manufacturers. China's extraordinary economic growth right now makes it one of the most important engines of the world economy outside of the United States. Put simply, in trade terms China today represents the fastest-growing market for U.S. goods and services. Our exports to China surged by 19 percent from 2000 to 2001, 15 percent from 2001 to 2002, and by 23 percent from 2002 to 2003, based on annualized figures.

China's Membership in the World Trade Organization

Since its accession to the World Trade Organization in December 2001, China has continued its course of ambitious economic reform in the transition to a rules-based, open economic system. One of the primary reasons for negotiating for 15 years with the Chinese over their accession to the WTO was to ensure that we would knock down the many barriers to entering China's market. The situation facing U.S. producers from a competitive perspective was far worse prior to China's entry into the WTO. Our exporters lacked access to the Chinese market, but Chinese producers had relatively free access to ours.

Today, by virtue of the WTO, the tariff rates that China imposes on our exports are lower on average than in most of the developing world, and in some instances, the developed world. In addition, China's WTO accession obligations require protection of the intellectual property of U.S. manufacturers and service suppliers. The agreement also phases out many of the barriers to the free distribution of American goods throughout the Chinese economy. American goods are increasingly able to move more freely through a variety of channels instead of being beholden to trading through a Chinese state enterprise, as in the past. Our farmers, manufacturers, and service providers all are finding new opportunities in the Chinese market.

China's WTO Compliance Record

Through the first two years following its accession to the WTO, China reviewed literally thousands of laws and regulations in an effort to make the necessary changes to bring them into compliance with WTO rules. Now, as we move further into China's participation in the WTO, we expect to see full enforcement of those laws and compliance with WTO rules in other areas. I know that the President, Ambassador Zoellick, Secretary Snow, Secretary Powell and most recently Secretary Evans have all made that point vigorously with their counterparts in China. And, I can attest that, at a working level, the rest of us have taken up the cause just as vigorously.

But there is still a very, very long way to go, which goes to the heart of the complaint many have about China. China seems to have lost its momentum in implementing its commitments. It is the pace of the ongoing reform of the Chinese economy toward a market model, of which the implementation of the Chinese WTO obligations is a part, that causes friction within our trade relationship. The WTO rules, and, indeed, the whole concept of trade are based on free competition in the marketplace. But, where one economy is organized under principles that are not completely consistent with that free market model, it can cause an enormous amount of friction within our trading relationships. Indeed, Secretary Evans articulated this key message in Beijing this past October.

Structural Concerns

China's transition to an economy that operates fully on market principles is far from complete. Without progress in the following areas, we at Commerce believe that China's other efforts to implement its WTO commitments will not be meaningful to U.S. companies. These are in addition to the list of specific issues that USTR will cover in its testimony. Let me briefly highlight four important areas of concern:

- 1. Protecting Intellectual property rights (IPR):** While China has put in place the legal framework to protect intellectual property, it lacks an effective enforcement system. Some estimate that over 90% of business software in China is pirated, costing the rightful owners more than \$1.5 billion a year in lost sales. Ensuring effective IPR enforcement is critical to doing business in China, not to mention protecting Chinese consumers from harmful products.
- 2. Increasing Transparency:** The cornerstone of every market economy is a rules-based, transparent system. Transparency commitments underlie all other commitments to adopt WTO-consistent measures. The lack of regulatory transparency in China continues to make for an unpredictable environment for foreign businesses in China.
- 3. Establishing Standards:** China is in the process of revising its standards system and adopting more international standards. However, in several areas we are seeing China adopt home-grown standards that are not based on inter-

national standards. China also continues to develop its standards in an opaque manner, in some cases not providing adequate comment periods or notice before establishing standards.

4. **Ensuring Non-discrimination/national treatment:** Whether it is through discriminatory value-added tax policies or through protectionist industrial policies, China's actions continue to raise concerns.

Notwithstanding these unresolved issues, we still believe China's leadership is earnest about its country's transformation to a market-based economy and has made much progress toward implementing its WTO commitments. For example, China recently took steps to improve the administration of the tariff-rate quota (TRQ) system for bulk agricultural commodities, such as wheat and cotton. China has also promised to keep the way clear for imports of soybeans, one of the top U.S. exports to China, as it implements its new biotech regulations. And during his recent visit to the United States, Chinese Premier Wen Jiabao stated his intention to work to increase U.S. exports to China as a means to address the trade imbalance between our two countries.

The Department of Commerce's Role in Trade With China

But we must remain vigilant. The Department of Commerce, in close coordination with USTR and other agencies, has adopted an aggressive and multi-pronged approach to ensure that China honors its WTO commitments and that U.S. companies benefit from these opportunities.

These efforts begin, and are greatly enhanced by, active engagement at the most senior levels of government. This past October, Secretary Evans traveled to China where he delivered a strong message, calling on the Chinese to ensure a level playing field in our trade relations and to create an economic system that is more transparent and that allows capital to flow freely in response to market forces. The Secretary's visit followed on the heels of visits by Treasury Secretary Snow and Ambassador Zoellick, during which similar messages were delivered. The Secretary and Ambassador Zoellick will continue this dialogue at an elevated meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT), to be held this April in Washington.

At the direction of Secretary Evans, the Department has devoted significant resources to monitoring China's progress in adhering to its WTO commitments. Specifically, each unit of the International Trade Administration plays a critical role in this process. The Trade Development unit maintains a unique relationship with U.S. industries, ensuring that ITA has first-hand knowledge of U.S. industry's needs at home and in China. The Foreign Commercial Service, which gives the Commerce Department a global reach in interacting with foreign governments on behalf of U.S. companies, maintains offices in five cities on the mainland of China, plus Hong Kong. This represents our largest presence of commercial officers in any single country throughout the world.

ITA's Market Access and Compliance, a unit whose mission is to monitor our trading partners' compliance with trade agreements, houses an office solely dedicated to monitoring China with respect to its WTO commitments. The China compliance office is staffed with 18 employees, up from only seven a few years ago. Market Access and Compliance, along with Import Administration, has deployed four officers, and employs several Chinese nationals, in its Trade Facilitation Office in Beijing to gather information on the Chinese economy and assist in our evaluation of whether China is meeting its obligations.

At Import Administration, we also have in place an ongoing monitoring program that tracks import trends as well as certain government policies, business conditions, and company practices regarding China. We pay particular attention to China's subsidization of its commercial sector, which assists us in our work at the WTO Subsidies Committee.

I would note that the lack of sufficient transparency in China has greatly hindered our ability to obtain detailed information on actual subsidy programs. Accentuating this transparency problem is the Chinese government's failure to make the annual notification of government programs that meet the definition of a "specific" subsidy under the WTO Subsidies Agreement, a notification required of all WTO members by June 30 of each year. China's failure to make its required notification for two years running, coupled with an overall lack of publicly-available information, greatly hinders our efforts to confirm whether China has complied with its accession obligations concerning subsidies. Apart from monitoring activities in China, ITA has also provided technical assistance to China since September 2000, in an effort to encourage and assist China in meeting its WTO commitments. Initial programs focused on increasing the awareness of general WTO principles among Chinese government officials. As China developed an increasingly sophisticated understanding

of the WTO system, however, our programs have been tailored to more specific areas, such as standards development, intellectual property rights protection, and the rule of law.

In 2003, ITA sponsored or coordinated programs on areas of primary importance to U.S. industry and has helped improve the environment for foreign firms conducting business in China. One such program on fertilizer standards played a role in the indefinite postponement of the issuance of standards that would have closed China's \$700 million fertilizer market to U.S. exports.

We continue to look for new ways in which we can utilize our expertise. Some programs already under development for this year include a health care forum and a standards development workshop, both to be held in Beijing. These programs allow us both to help the Chinese comply with their WTO obligations and to assist U.S. firms in expanding their businesses through trade with China.

While the Department will continue its focus on China's compliance activities, it is critical to continue to enhance the ability of U.S. businesses to compete in China. As China's market becomes open to foreign trade and investment, American companies will be competing with the rest of the world to gain access to rapidly expanding Chinese consumer markets. To that end, the information and expertise that we gain through participation in cooperative programs with the Chinese is shared with U.S. businesses, especially small- and medium-sized companies, here at home. Last year, ITA initiated its "Doing Business in China" seminar that will again be presented in cities across the country this year. These seminars are designed to assist U.S. companies, especially small- and medium-sized ones, gain the tools to be competitive in the Chinese market.

Finally, we are not only identifying areas in which China should change, we are also changing ourselves. For the first time in 20 years, plans have begun to implement an ITA reorganization that will equip us to more effectively meet the needs of U.S. industry and create a fair playing field for U.S. businesses trading with China.

Commerce will integrate and streamline the operations and procedures of export promotion services within the Department under a new Assistant Secretary for Trade Promotion. Funds have been allocated under this office to create a China Business Information Center. To further assist U.S. exporters, ITA will create at least six positions in American Trading Centers, to be established in major commercial centers around China. We expect that these changes will allow us to promote U.S. imports more aggressively in China and actively engage the Chinese on issues that matter most to U.S. companies.

Within Import Administration we are creating a new Unfair Trade Practices Task Force, a unit designed to strengthen ITA's ability to advance U.S. trade policies and negotiations and address the root causes of unfair trade. This task force will be analyzing market trends, trade flows and government actions to identify potential unfair trade practices and arrange consultations with governments in an attempt to preemptively resolve nascent unfair trade matters before they develop into disputes and result in trade cases. With respect to China, the task force has begun tracking imports from China in 30 key sectors in order to identify unfair trade practices. We will begin consulting with industry representatives to determine specific actions we can take in other sectors, as well.

Finally, to better address concerns on the effective enforcement of the trade laws with respect to China, Import Administration is in the process of creating a China Enforcement Office that will focus on anti-dumping cases brought by U.S. producers injured by Chinese imports. Imports from China represent a rapidly growing source of trade complaints. In fact, during the last three years, we have initiated more antidumping investigations and imposed more antidumping orders covering products from China than any other country, more than twice as many as the next leading country. In 2003 alone, more than 50 percent of all new antidumping orders put in place have involved China, up from historical levels of just under 20%. This new office will further cultivate the expertise necessary to address the unique problems encountered in the Chinese economy, and will review current policies and methodologies (including the Department's non-market economy methodology (NME) and new shipper reviews) to ensure that the trade laws work to the benefit of the United States.

Based on all of these activities, I can assure you that the Department of Commerce is dedicated to making sure China plays by the rules that it agreed to upon entering the WTO, and that American companies will be poised to take advantage of a more level playing field between the United States and China. We have already seen great progress in the form of record levels of U.S. exports to China. But much more work is still to be done and the tools we are putting in place will help us accomplish the goal of fully integrating China into a rules-based trading system.

In conclusion, I want to stress that this Administration is mindful of the importance of our trade relationship with China, and its place in world markets. While we believe that China's leadership is serious about economic reform and its WTO commitments, China still has a long way to go. We will continue to work with our inter-agency counterparts and the Congress to ensure that all Americans enjoy the benefits of free and fair trade.

Thank you for giving me this opportunity to testify on this important topic. I appreciate your support for our efforts and welcome your questions.

**STATEMENT OF RANDALL SCHRIVER
DEPUTY ASSISTANT SECRETARY, DEPARTMENT OF STATE**

Mr. SCHRIVER. Thank you, Mr. Chairman and Members of the Commission. I also appreciate the opportunity to address the Commission today on this important topic.

It's, I think, my job from the State Department perspective to talk about how China and the WTO issue fits into our overall bilateral relationship and our overall strategy to try to integrate China into the global community as a constructive force for stability and prosperity. The President, my Secretary, and of course our entire Administration have worked very hard on this relationship.

We have worked to have a forward-looking relationship guided by the following principle: that we can build on areas where we have common interests but also address our differences in a very direct, straightforward and candid manner. We have developed a very wide-ranging dialogue with the Chinese, and this includes issues that are most critical to our national security, issues such as the challenges on the Korean peninsula and the global war on terror.

At the same time, we have not shied away nor will we shy away from addressing these areas where we do have differences, areas such as human rights, nonproliferation, Tibet, Taiwan and questions about market access. In this overall context, developing a trade relationship that is beneficial for the United States is a top priority for the Administration.

And while we believe a strong trade relationship fits into this category of shared interests and common interests, we do have important differences with China with respect to its current practices. And let me assure you in those areas, we do address them in a very direct way.

We do this first and foremost because we want the United States to benefit from China's membership in the WTO, but we also do this because we believe it can help promote some broader goals. China's meeting its WTO commitments will help promote China's continued economic reform, modernization and opening. We can also help to ensure that China becomes a responsible member of the rules-based global economic system.

We also believe that China's meeting its World Trade Organization commitments may have a residual benefit of further opening in the political realm and human rights realm.

On WTO, clearly, China needs to do better. China has made some progress, but as has already been pointed out, and as I'm sure my colleagues will expand upon, we continue to have serious concerns about China's WTO compliance, particularly in some critical areas such as agriculture, intellectual property rights, the service sector and the cross-cutting issues surrounding transparency.

While China's imports from the U.S. are reaching new heights, better market access is still needed. The State Department is working closely with our interagency colleagues and through our embassy with the Chinese government to address our concerns about WTO implementation. And when China's good intentions on WTO commitments do not translate into positive results, we stand ready with our interagency colleagues to use multilateral means, including WTO dispute settlement, to enforce those commitments.

Let me make note of some of our ongoing efforts. The State Department, both in Washington and in our posts in China, plays a role in the monitoring and enforcement of China's implementation of WTO commitments. This is a very extensive effort that includes a range of activities: monitoring Chinese press, Government websites, monitoring government activities to try to get a fix on how China is performing.

It also includes our embassy officials traveling around China to different parts of the country to see how commitments are being met in local areas and provinces. And I would also note that our U.S. consulate in Hong Kong plays a role as well, particularly given their excellent contacts with the business community there that has unique insights into how China is doing at meeting its WTO commitments.

We are also involved with our interagency colleagues sponsoring training and providing information to not only U.S. industry but also the Chinese government, and in fact, our embassy, with colleagues, has sponsored roundtables and information sessions where both U.S. industry and Chinese officials have been present to facilitate a dialogue between the two.

We are also working to establish more effective channels for influencing China's economic policies. This is across the range of the Administration, the State Department. We have a role in this; our Undersecretary for Economic and Business Affairs has established a dialogue related to economic reform with China's National Development and Reform Commission, a very powerful planning body within China.

And finally, at the State Department, we play a role in keeping the trade and WTO issues among our top agenda items. I think it makes a difference when our senior leaders have discussions with our Chinese interlocutors, and they know trade is right at the top of the list along with issues such as the global war on terror and our challenges on the Korean peninsula.

To conclude, I would like to emphasize again that making U.S.-China economic relations benefit the United States is a top priority for the State Department and the entire Administration. We are committed to addressing WTO concerns to ensure that U.S. workers, farmers and consumers get the full benefits of China's membership.

China has made progress in implementing its WTO commitments. But we are not satisfied. We are determined to do all within our power to ensure that China does more to implement its WTO accession commitments and to implement them on time. And again, we work very well with our interagency colleagues to that end. Thank you, and I look forward to your questions.

[The statement follows:]

**Prepared Statement of Randall G. Schriver
Deputy Assistant Secretary of State
East Asian and Pacific Affairs, Department of State**

Mr. Chairman, thank you. I appreciate the opportunity to testify before the Commission today. I am pleased to be here today with Commerce Assistant Secretary James Jochum, Deputy Assistant USTR Charles Freeman and Foreign Agricultural Services Deputy Administrator Patricia Sheikh, who will be able to comment knowledgeably and in depth on China's compliance with its WTO obligations. For my part, I welcome the opportunity to discuss how China's WTO efforts fit into our overall efforts to develop our relationship with China.

Overall China Policy

President Bush, Secretary Powell, and this Administration overall have worked hard to forge a dynamic, forward-looking relationship with China, one that is guided by a determination to build on our common interests, while addressing our differences in a straightforward manner. We have a wide-ranging dialogue on issues where we share compatible views on matters critical to U.S. national security, including the situation on the Korean peninsula and the global war against terrorism. At the same time, we have not shied away from candidly addressing those areas where we disagree—human rights, nonproliferation, Taiwan and market access. As China's role in global affairs increases, we are working to find ways in which together we can promote peace, security and prosperity in the world.

The quality of our dialogue has improved as the number of our direct face-to-face senior-level meetings has increased. The President has met with China's President, Jiang Zemin or Hu Jintao, an unprecedented five times since taking office, most recently at the October 2003 APEC meetings in Bangkok. He also hosted Premier Wen Jiabao in early December at the White House. Our expanding economic relationship has been very high on the agenda at each of these meetings.

WTO and Economic Reform

As we continue to broaden and deepen our framework of economic and trade ties, we need to pay special attention to China's implementation of its World Trade Organization commitments. Getting China to implement fully and on time its WTO commitments is the cornerstone on which we build our bilateral economic policy. China's WTO membership and fulfillment of its WTO accession commitments are closely linked to key economic policy goals that include:

- Promoting China's continued economic reform, modernization and opening.
- Ensuring China becomes a responsible member of the rules-based global economic system.
- Encouraging China's contribution to economic growth in the region and the world through market-oriented reform and development.

Market reforms and economic engagement have unleashed individual initiative and entrepreneurship and even led the Chinese communist party in recent years to revise its constitution to do the unthinkable—admit private entrepreneurs into membership. This March, the National People's Congress is expected to revise the State Constitution to enhance legal protection for private property rights. These changes—which started long before China became a WTO member—have increased opportunities for Chinese to engage in business and commercial activity outside what was once the sole purview of the state. China, of course, still has a long way to go before it develops into a transparent, open, rules-based, market economy, but it has made a start.

A start, I believe, that is accelerating in the aftermath of China's entry into the WTO. Accelerating as well are export and investment opportunities for U.S. companies. This translates into more jobs for American workers and farmers. This also means more and better choices of low cost, high quality products for American consumers.

WTO Implementation

Let me assure you we have candid conversations with China on WTO implementation. We want to ensure that the U.S. economy gets the full benefits of China's WTO membership.

First, we endorse USTR's report on China's compliance record that was submitted to Congress in December. The State Department, especially through our posts in China, made an important contribution to the preparation of the report. This contribution includes following closely changes in Chinese laws and regulations, meeting frequently with diplomatic counterparts and business people throughout the

country to hear their views about WTO implementation, and analyzing the reality behind the surface of Chinese pronouncements.

China has made some progress in meeting its WTO commitments. However, as USTR clearly pointed out, we have serious concerns about China's WTO compliance in certain areas—including agriculture, intellectual property rights, the services sector, and on the cross-cutting issue of transparency. We are determined to do all within our power to ensure that China does more to implement its WTO accession commitments, and to implement them on time.

Second, the combination of China's strong economic growth—over 9% in 2003—and increased market access tied to WTO implementation and U.S. trade pressure has produced some positive results in key trade areas. U.S. exports to China are reaching new heights, increasing around 25% through November 2003 to \$25 billion, after having grown 15% in 2002. China is our fastest growing export market. U.S. agricultural exports to China—especially soybeans and cotton—have seen tremendous growth, more than doubling in value to \$4.5 billion through November 2003. At the same time, we enjoy a growing trade surplus in services as U.S. investment banks, insurers and accounting firms continue to make inroads into the China market. Better market access was one of the key U.S. goals of getting China into the WTO and we are making headway, not enough to be sure, but the direction for some of our goods and services is right.

Third, there is a strong and well-coordinated interagency effort on China WTO Compliance. The State Department is working closely with USTR, the Commerce and Agriculture Departments, and through our Embassy with the Chinese government, to address our concerns about China's WTO implementation. When China's good intentions on WTO commitments do not translate into positive results, we stand ready to use multilateral means, including WTO dispute settlement, to enforce those commitments.

Expanded Dialogue

I would note that the Administration has made a determined effort over the last year to establish more effective channels for influencing China's economic policies—including those related to WTO membership.

Over the past year we have initiated, or begun planning for, a series of high-level meetings to take a closer look at our economic relationship. Ambassador Zoellick and Secretary Evans will co-chair an expanded Joint Commission on Commerce and Trade meeting during Vice Premier Wu Yi's visit this April. We are looking to this forum to make progress on lingering trade problems, especially those related to WTO implementation. Treasury Secretary Snow also has invited Chinese Vice Premier Huang Ju for an intensive dialogue on financial issues and we are hopeful that visit will take place in the first half of the year. And finally, during a visit to Beijing last November, State Department Under Secretary for Economic, Business and Agricultural Affairs Alan Larson initiated a dialogue on economic reform issues with the National Development and Reform Commission, China's powerful planning body.

State's Role

As I noted earlier, the State Department, both in Washington and at our posts in China, plays a critical role in the U.S. Government's efforts to monitor and enforce China's implementation of its WTO commitments. In addition to working closely with other USG agencies to address specific trade concerns, State brings to the table a perspective on how China's WTO policies affect overall U.S. foreign and economic policy and U.S.-China bilateral relations. WTO implementation cannot be considered in the abstract, but as I said earlier, it must be seen as part of an overall strategy of integrating China into the global community as a constructive force for stability and prosperity.

I do not think it possible to overstate the contribution of our China posts to overall USG efforts to improve China's WTO compliance. Some specific examples of their contributions include:

- To develop a strategy to improve China's weak protection of intellectual property rights and to press China on our concerns, Ambassador Sandy Randt hosted two, all-day roundtables with over 100 industry participants as well as USG and Chinese officials. At the November 2003 roundtable, Vice Premier Wu Yi, who now heads China's effort to strengthen IPR protection, was the keynote luncheon speaker. The U.S. Embassy in China followed up on this event by compiling an IPR White Paper highlighting key industry concerns and recommendations for presentation to the Vice Premier.
- To keep Washington agencies informed, the U.S. Embassy staff in Beijing monitors Chinese language news sources as well as PRC government and academic websites for WTO-related laws, regulations and developments. Key information

is disseminated informally in the near daily "WTO Notes" report and in more detailed cables.

- Our staff, both in the U.S. Embassy and at the four U.S. Consulates General, travel throughout China to observe and report on WTO compliance and WTO-related developments in local and provincial areas. They also use such opportunities to engage local officials and academics on WTO issues.
- Our China posts, especially the U.S. Embassy in Beijing, also provide substantive and logistical support for a multitude of U.S. Government visitors to China for WTO-related meetings and negotiations. These visits are crucial for making progress on our concerns but the frequency can stretch the staff to the limit. In one three-week period last October, Ambassador Zoellick, Commerce Secretary Evans, high-level NSC/USTR officials, and several other important USG delegations all visited Beijing separately.

I would also note that the U.S. Consulate General in Hong Kong is an excellent source of information on China's WTO efforts. Our staff there tap into the resources of one of the world's largest American Chambers of Commerce and talk with Hong Kong business people who are savvy about Chinese compliance efforts.

While we are convinced that our China posts are doing excellent and important work, we also believe that their performance could be enhanced with additional resources. State's Economic section in Beijing has only six full-time equivalent officers and staff to handle the full range of WTO issues. Our Consulates each have at least one officer handling WTO issues but normally these officers are also responsible for other economic issues. Similarly, in Washington we currently have three officers on our "China Desk" handling U.S.-China economic relations, including WTO issues. Officers in our Economic Bureau, who have functional responsibilities for a wide range of countries, including China, round out State's China economic team, but we remain a streamlined operation.

More resources, both here and in China, are needed. We have done our best to do more with less, but we are stretched thin. In the future, as our trade and economic relationship with China continues to grow, additional staff and resources will be essential. Monitoring China's compliance with its WTO commitments is really only the start of our efforts. We need to engage China in a full-time dialogue about the new Doha Round covering both the new commitments they are prepared to make and the support they may be able to provide the U.S. on a variety of IPR, services and agriculture issues.

Other issues do not relate directly to the WTO, but are just as important to U.S. economic interests. For example, China recently announced rules that will give a preference to domestic software in government procurement. China is not yet a member of the WTO Government Procurement Agreement, so the WTO grounds available to challenge China's new rules are limited. Nevertheless, the policy is misguided, may make other Chinese companies less competitive, and will likely harm the prospects for U.S. software firms in China. We are taking a variety of actions to convince China to modify the new rules.

Conclusion

To conclude, I would like to emphasize again that making U.S.-China economic relations benefit both the United States and China is a top priority for the State Department. Getting China to implement fully and on time its WTO commitments is the cornerstone of achieving this objective. As with other issues in our relationship, we are committed to addressing WTO concerns in a candid but cooperative manner to ensure that U.S. workers, farmers and consumers get the full benefits of China's WTO membership. China has clearly made progress in implementing its WTO commitments but we are not satisfied. Working with USTR, Commerce, Agriculture and other USG agencies, the State Department will continue to urge China to enter more fully into the kind of rules-based, transparent economic system that promotes the prosperity of all.

Thank you.

Co-Chair MULLOY. Thank you, Mr. Schriver. Mr. Freeman, USTR actually chairs the interagency committees that are in charge of this area, so your testimony is very important, and we appreciate your being here.

STATEMENT OF CHARLES FREEMAN DEPUTY ASSISTANT U.S. TRADE REPRESENTATIVE

Mr. FREEMAN. Mr. Chairman, thank you very much for both the opportunity to be here and for the chance to speak out on what is

an area of abiding importance to the Administration and to USTR in particular.

We are a very small agency, as many of you know. There are just over 200 of us, and despite the range of issues with which we are currently involved and with which Ambassador Zoellick is currently involved, China enforcement is very much a key issue. It takes a disproportionate amount of time, of Ambassador Zoellick's time as well as of Ambassador Josette Sheeran Shiner, his deputy, as well as our general counsel. It's very much not in the rear view mirror, as Senator Dorgan said.

We—in December, we put out an annual report on China's WTO compliance which is due to Congress every year, and I don't want to go into the depth of discussions that that report covers, but let me briefly summarize some of the issues that are contained therein.

First of all, as Jim Jochum said, business to China is actually not bad. Our businesspeople report that they are doing pretty well in China, all things considered. And one of the things that we struggle with is hearing the Chinese that their economy in general is more open than your average developing economy, that their trade balance is roughly balanced, that our businesses are not complaining to them.

One of the things that we have to stress is that examples of business successes do not necessarily equate to WTO compliance. The 15 years of negotiations that led up to the bilateral agreement that let China into the WTO was really focused on trying to ensure that the performance and the changes in China were systemic in nature; that they were focused on market opening for China and making sure that the government could be removed from active interference and active planning in economic decision making. And by that score, I have to say China's compliance with its WTO commitments leaves something to be desired.

We are very focused on market access for our firms in China. That is our primary concern. That is our abiding effort. And in that area, there are four—roughly, four or five areas Jim has already alluded to and Randy as well. And without prioritizing, let me just talk a little bit about the areas of key concern with us from a WTO compliance standard.

IPR, intellectual property rights is, of course, tremendously challenging to us and to the Chinese as well. Enforcement of IPR is very lax, to say the least, as any of you who have been to China, who have stepped out of your hotel door will know, buying a copy of a first run U.S. movie is almost—you can do it within moments of stepping out the door.

But it's not simply a question of movies or DVDs or other media; really, anything that China—that can be produced, China can counterfeit. And that leads us into some very disturbing areas.

Clearly, we are concerned, for economic and other reasons, about the need to protect our creative industries, but we are seeing increasingly areas of concern with respect to things like auto brakes and auto windshields and things that really present a health and safety concern, not just to us to the extent these are exported to our country, but also to China.

The troubling thing or the difficult thing is that the senior leadership in China really speaks a very good game on this issue and recognizes—and I believe does a significant amount of hand wringing about the level of counterfeiting and piracy and PR non-enforcement in their country. But translating that level of concern and hand wringing down to the level of enforcement is not taking place.

Other areas that we are particularly concerned about, again, I don't want to say that these are necessarily the priorities in order, but broadly speaking, agriculture policies, there are a variety of actions which the Chinese are taking and I know Pat will talk about as well with respect to sanitary and phytosanitary measures, standards for agricultural products, that go beyond mere scientific bases or sound scientific bases. And the Chinese assure us and to quote Senator Dorgan again, that there are no isolationist xenophobic stooges in China, but there are increasingly some questions about the reasons that some of these decisions are being taken when we hear, at the same time as we complain about these standards, we hear about the importance of making sure that China's agricultural base and the Chinese farmers are protected from scary imports from the United States.

Other areas that we're focused on, again, services generally. China has made it a priority to limit the number of services firms from the United States and other foreign WTO members in its market. They are trying to have certain sizes of firms and certain scopes of business, and that really does, in our view, fall short of some of the things that our services firms believed they were getting as a result of the WTO deal and also falls short of what we believed we were negotiating.

Also, very importantly, within services, there is a notion of trading and distribution services, which is really, in many cases, where the rubber meets the road for exports. It is one thing to be able to say we can export to China. It is another thing to actually be able to take that export and distribute it within the Chinese market. That is still very much in process and hasn't been put in place within China.

And again, on the subject of transparency, really, that's kind of the key way we are able to determine whether China is meeting many of its commitments, and to the extent that China still operates in a fairly opaque manner—they are getting much better, but they still are—the level of transparency and decision making and regulatory rulemaking is still very uneven.

And finally, as Jim has said, one of the things that we are increasingly concerned about is both standards and industrial policies that very much seem to promote the idea of Chinese-only industrial development to the exclusion of foreign competition; again, not in keeping with either the letter or spirit of China's WTO commitments.

Let me just close quickly, if I can, with sort of the process with which we are engaging the Chinese. We have a very active engagement bilaterally, and that is our primary means of resolving difficulties, and for the most part the level of engagement has been quite good. The level of cooperation with the Chinese has been quite good. There have been many cases where the complaints that

we have brought have been addressed on a bilateral level. There have been others where the jury is still out.

We have not only an active regulatory dialogue, or, excuse me, a trade dialogue, at the working level, at the subcabinet level. President Bush and Premier Wen announced in December that the Joint Commission on Commerce and Trade, which has been nominally a Commerce to Ministry of Commerce, formerly Ministry of Trade and Economic Cooperation, dialogue has been expanded. So this April, Ambassador Zoellick and Secretary Evans get to co-chair on one side with Vice-Premier Wu Yi on the other. So that is an opportunity to actually have decision makers in the room to address specific and the most troublesome of our economic problems and attempt to resolve them at the table, something we have had trouble doing before.

I took note of Chairman D'Amato's comments with respect to the level of enforcement in Geneva. China's Geneva mission is still, in our view a work in progress. They don't have the ear of Beijing to the extent they need to. We have a variety of processes with which we engage the Chinese both bilaterally and multilaterally in Geneva. You alluded to the transitional review mechanism. That is certainly one means that we have of trying to make sure that China lives up to the—or to make sure we get the information about China's compliance with its WTO commitments. But it's not the only bite at the apple. We do have the ongoing committee process, which, very frankly, for a variety of reasons—Chairman Robinson alluded to the discriminatory nature of China's concerns—they have been much more cooperative with us in the normal committee process than they have in the transitional review mechanism, and I'm certainly happy to answer questions about that as well.

But again, let me just say in closing that we are extraordinarily focused on getting China's WTO compliance right. It is a matter that we take extremely seriously, not simply because it's of concern to the Congress but because it's of great concern to us.

The entire point of getting China into a rule-making body was to try to bring them into a more rational internationalist frame of mind, and that's why we are, I think, primarily focused on getting their compliance with their commitments up to speed.

Thanks. Happy to answer your questions.

[The statement follows:]

**Prepared Testimony of Deputy Assistant
U.S. Trade Representative Charles W. Freeman III**

Overview

Chairman Robinson, Vice Chairman D'Amato, Hearing Co-Chairmen Reinsch and Mulloy and Members of the Commission, I appreciate the opportunity to testify today on China's compliance with its obligations to the World Trade Organization (WTO) and on the process of monitoring and enforcing China's adherence to these obligations. This is a subject of considerable importance to the President and Ambassador Zoellick, and a matter of great priority to the Administration and to USTR in particular, in our capacity as the lead agency with responsibility for trade policy.

China has now been a member of the WTO for more than two years, having acceded to the WTO on December 11, 2001, after 15 years of negotiations with the United States and other WTO members. Under the terms of its accession, China committed to a set of sweeping reforms: implementation of the WTO's market access, national treatment and transparency standards; protection and enforcement of intellectual property rights; disciplines on the use of trade-distorting subsidies; and other changes to bring its legal and regulatory system in line with those of other

WTO members. China viewed joining the WTO as a means to preserve and expand China's access to export markets abroad, particularly the United States. In turn, other WTO members envisioned that faithful WTO implementation by China would reduce the ability of the government to intervene in the market to direct or restrain trade flows.

While statistical information for 2003 is not yet fully available, total U.S.-China trade last year is believed to have topped \$170 billion, with imports from China exceeding U.S. exports by more than \$120 billion. China has become the United States' third largest trading partner, passing Mexico as our second largest source of imports in 2003 and becoming the sixth largest market for U.S. exports. Imports from China are not only growing rapidly, but are increasingly displacing those from other economies - including in Asia and Latin America. While in real terms import numbers are outpacing exports to China, the growth rate of exports to China is in line with, or even outpacing, that of imports. Over the last three years, while U.S. exports to the world have decreased by 9 percent, exports to China have increased by 62 percent. China has become a major consumer of U.S. manufactured exports, such as electrical machinery and numerous types of components, among other goods. China is a major importer of agricultural products from the United States, and U.S. service providers have been increasing their share of China's market in many sectors as well.

But neither volume of trade statistics nor anecdotal evidence of U.S. business successes in China are the yardsticks by which the Administration measures China's compliance with its trade agreements. China's accession to the WTO was conditioned on China's commitment to establish an open, transparent trade regime and to play by the rules of international trade. In that sense, the true measure of China's compliance with its WTO commitments is the extent to which China has institutionalized market mechanisms and curtailed direct governmental actions or complicity with non-governmental actions to intervene in the marketplace. By that score, China's WTO compliance record falls short of the mark.

As discussed in USTR's second annual Report to Congress on China's Compliance with its WTO Commitments, China has made important headway since its WTO accession two years ago, and has completed much of the nuts and bolts work of WTO implementation. It has reviewed thousands of laws and regulations and made changes necessary to effect many of its WTO commitments; established new transparency procedures in many national and sub-national ministries and agencies; and reduced tariffs to their committed levels, among other things.

Despite these gains, China's compliance with its WTO commitments has, over the past two years, been uneven. The Administration has engaged the Chinese government at every opportunity, whether through discussions in Washington or Beijing or at the WTO in Geneva, to address perceived shortcomings. In some cases, USTR and other agencies were able to resolve U.S. concerns. For example, China has taken steps to correct systemic problems in its administration of the tariff-rate quota (TRQ) system for bulk agricultural commodities. It relaxed certain constraints in soybeans trade that allowed U.S. exporters to achieve record sales. It reduced capitalization requirements in some financial services sectors. It opened up the motor vehicle financing sector. It solved outstanding concerns that had prevented China's membership in the WTO's Committee of Participants in the Expansion of Trade in Information Technology Products.

In the first year following WTO accession, China's incomplete implementation of WTO commitments could, in some cases, be attributed to start-up problems or incomplete understanding of WTO rules and practices. These rationales are less meaningful two years into WTO membership. In fact, while China made significant initial strides in its first year, China's WTO efforts seemed to have lost a fair amount of momentum last year. Institutionalized market mechanisms remain elusive, and intervention by China's government officials in the market is not uncommon.

China's WTO implementation efforts, it should be noted, have taken place against a challenging political and social backdrop. In 2003, China underwent a major leadership change, passed through a harrowing national SARS epidemic, undertook a sizeable restructuring of the government's economic and trade functions, and confronted a host of dislocations inherent in its transition from a planned economy to a more market-oriented economy. These factors may have presented challenges, but they are not grounds for foot-dragging in implementing WTO commitments.

The Administration is determined to continue to address market access problems that contribute to our trade deficit with China and to ensure that China operates with fair, transparent and predictable rules. That means, most importantly, that China must live up to the commitments that it made upon joining the WTO. We also need to ensure that China engages in fair trade when it comes to its exports

to the United States. Our companies want, and are entitled to, a level playing field. Some key areas that will require more work from China in order to achieve WTO compliance, in the view of the Administration, include:

- Obligations to fully open its agricultural market and to refrain from the use of arbitrary limitations on market access, including sanitary and phytosanitary measures not based on science;
- Enforcement of intellectual property rights, including through the use of deterrent-level criminal penalties as appropriate, and restriction on exports of counterfeit or other IPR-infringing goods;
- Commitment to provide for full liberalization of trading rights and distribution services;
- Use of fair and transparent standards and technical regulations, including the establishment of procedures that ensure the public's right to comment on proposed measures; and
- National treatment (including non-discriminatory taxation) and market access for U.S. goods and services.

U.S. Management of WTO Implementation Concerns

The Administration has stepped up its efforts to engage China's senior leaders on trade issues. Over the past year, as China's WTO implementation progress has slowed, President Bush met with his counterpart, Hu Jintao, and emphasized the importance of China's WTO obligations. United States Trade Representative Zoellick made two separate visits to China for talks on WTO implementation matters with China's Premier, Wen Jiabao, and Vice Premier Wu Yi. The Secretaries of Commerce and Treasury made similar trips to China, again carrying the message that China's WTO implementation was a matter of the highest priority. Sub-cabinet officials from various U.S. economic and trade agencies also met with their Chinese counterparts in China, Washington and Geneva to work through areas of concern, including WTO implementation issues, on numerous other occasions.

USTR's monitoring of China's WTO implementation is managed by the Office of North Asian Affairs. Our China team, while small, works closely with experts from the sectoral offices at USTR, as well as the Office of the General Counsel. In addition, USTR's role as chair of the Trade Policy Staff Committee's subcommittee on China's WTO Compliance allows us to manage trade concerns in close consultation with relevant agencies throughout the Administration.

In 2003, the Administration also utilized the newly established sub-cabinet dialogue on WTO compliance and other trade matters (the Trade Dialogue), which brings together U.S. economic and trade agencies and various Chinese ministries and agencies with a role in China's WTO implementation. Trade Dialogue meetings were convened twice in 2003, once in February, led by then Deputy United States Trade Representative Huntsman, and later in November, led by Deputy United States Trade Representative Josette Sheeran Shiner. The Trade Dialogue meetings have proven to be effective in communicating specific trade concerns and in serving as an early warning mechanism for emerging trade disputes.

In December 2003, President Bush and Chinese Premier Wen Jiabao agreed that the meetings of the annual U.S.-China Joint Commission on Commerce and Trade (JCCT) should be used to resolve issues that contribute to imbalances in the economic relationship. To that end, in April 2004, the JCCT will be convened with Secretary Evans and Ambassador Zoellick as co-chairs on the U.S. side, and Vice Premier Wu Yi on the Chinese side. The elevation of the JCCT dialogue in this way should prove a useful opportunity to heighten attention of U.S. and Chinese authorities to concerns with China's WTO implementation, and make further progress on these concerns.

Of course, there are forces in China, as elsewhere, that are resistant to the changes wrought by WTO implementation. Despite the best of intentions by many Chinese officials, these forces have not been unsuccessful in limiting China's progress toward the goals the United States and other WTO members set for China's WTO accession. As a result, China's market for U.S. goods and services is not as open as it should be, our engagement with China in the WTO has not been as useful as it should be, and China's record of WTO implementation is more inconsistent than it should be.

Enforcement of Trade Remedies Laws

The rapid expansion of trade between our two countries has inevitably led in some cases to competition between our domestically produced goods and Chinese imports. When our industries face injurious trade with China, the Administration is fully committed to enforcing U.S. trade remedy laws and to exercising the important rights that the United States has under China's WTO accession agreement, includ-

ing our ability to continue to apply special methodologies to China under the anti-dumping laws.

China also agreed to two separate China-specific safeguard mechanisms to allow WTO members to cope with market disruptions caused by increasing economic integration with China. One such mechanism, the product-specific safeguard, was codified as Section 421 of the Trade Act of 1974, as amended, and is available until December 11, 2013. Since the implementation of Section 421, four petitions have been brought requesting import relief. In one case, the International Trade Commission found that our domestic producers' market had not been disrupted by imports from China. In two other cases, while the ITC found market disruption, the President determined that the adverse impact on the U.S. economy was clearly greater than the benefits from providing import relief. On December 4, 2003 the ITC found market disruption in the fourth case, and the President will make a determination on import relief in early March this year. While to date no import relief has been granted under Section 421, the President, in his most recent determination, reiterated his commitment to using the safeguard when the circumstances of a particular case warrant.

The second safeguard agreed to by China as part of its WTO accession package is specific to textiles, and allows WTO members under certain circumstances to invoke limited import relief—specifically a 7.5 percent cap on growth in imports of a given textile category for up to one year (6 percent for wool products)—until December 31, 2008. In December last year, the Committee for Implementation of Textile Agreements (CITA) found for petitioners in all three of the initial investigations it agreed to review and import relief is currently in place.

Transitional Review Mechanism

China was admitted to the WTO on somewhat unique terms with some limited transition periods, given that its transition to becoming a market-oriented economy is still in process. Accordingly, the WTO conducts an annual review of China's implementation progress, known as the Transitional Review Mechanism (TRM). This review, which took place in each of the last two years and will take place in seven of the next eight years in 16 subsidiary bodies as a lead-up to the year-end meeting of the WTO's General Council, is an opportunity for other WTO members to engage China on the extent to which it has complied with its commitments and to clarify China's trade practices.

The first year of the TRM was marked by some misunderstanding between China and other WTO members as to expectations of China at the TRM, but communication improved as the process unfolded. The second year was marked by significantly less conflict between members and China over China's TRM responsibilities, and overall China did provide more information about its WTO implementation efforts last year as compared to the previous year, but the process still fell short of being a thorough, meaningful review of China's implementation efforts. Indeed, while China devoted extensive energy and resources to fulfill the requirements of the TRM, it also spent considerable time and energy challenging fundamental procedural processes that acted to frustrate the essential intent of the TRM. This may in part be due to a contention that the TRM, as it applies uniquely to China, is a discriminatory process. However, given the special circumstances under which China entered the WTO, there is little justification for China's apparent position that China should not be required to provide members concrete evidence that it is implementing its post-accession commitments. USTR will continue to press for China's full cooperation in the TRM, working closely with other members with common interests.

Conclusion

While the U.S.-China economic and trade relationship is growing rapidly, there is a number of structural impediments that remain, making further improvements in that relationship problematic. The Administration is committed to resolving the United States' concerns through all available mechanisms. If cooperative or bilateral efforts are not productive, or if it becomes clear that engagement on any given issue has reached stasis, the Administration is fully prepared to assert the United States' rights through multilateral means, including dispute resolution at the WTO.

Co-Chair MULLOY. Thank you very much, Mr. Freeman. That was a very forthright presentation.

I just want to point out that we're going to continue this hearing in the afternoon and Commissioner Reinsch is going to chair that part of the hearing. We are going to hear from industries that are concerned about IPR violation, about services access, about agricul-

tural access, and then, we are also going to hear from labor's views on some of these issues as well.

So, Ms. Sheikh, if you could give us your testimony from the perspective of the Agriculture Department.

STATEMENT OF PATRICIA R. SHEIKH, FAS DEPUTY ADMINISTRATOR

Ms. SHEIKH. Thank you, Mr. Chairman and Members of the Commission for the opportunity to appear before you again to discuss how the United States is monitoring China's WTO compliance.

The dramatic growth in China's demand for agricultural products, including soybeans, hides and skins, cotton and hardwood lumber is also accompanied by a number of nontariff barriers, non-transparent regulations and behind the scenes interference in trade by China's central government.

In essence, we are seeing improved market access, but that access is often inconsistent and erratic. While problem areas remain, we have clearly made progress on many fronts, as evidenced by some very impressive trade figures. Since China joined the WTO in December of 2001, U.S. agricultural exports have more than doubled, from just over \$2 billion in 2002 to a record \$4.1 billion for the first 11 months of 2003.

If forest and fishery products are included in that total, then the corresponding rise is from \$2.2 billion to \$4.5 billion. In the years ahead, we fully expect new export opportunities for a broad range of U.S. agricultural products, including grains, dairy products, milk and processed goods in this market of 1.3 billion people.

This dramatic growth in trade with China has not been realized without some difficulty. A major threat to U.S. trade interests continues to be the way that China periodically veers from its WTO commitments by asserting central controls. U.S. agricultural exporters have been confronted with an array of nontariff trade barriers such as tariff rate quota administration problems, unscientific sanitary and phytosanitary barriers, trade restrictive biotechnology regulations and complex, confusing licensing requirements.

Control and administrative guidance is also evidenced in the form of state trading, quantitative directives, prohibited export subsidies and threats of retaliation. Many observers within U.S. Agriculture believe that the Government of China provides administrative guidance that imports not exceed planned levels.

I would like to highlight for you two areas that were of particular concern to the USDA in 2002 and 2003 and which we continue to monitor. The first instance involves China's commitments related to tariff rate quotas or TRQs on bulk agricultural commodities, including wheat, corn, cotton and vegetable oils.

Since China's State Development Reform Commission, or what was known as the SDRC, now known as the National Development and Reform Commission or NDRC, began implementing these commitments following China's accession, a series of problems served to undermine the market access envisioned by all WTO members.

SDRC's performance in 2002 improved in certain respects, most notably in completing that year's reallocation of agricultural commodities in a timely manner. Nevertheless, the Foreign Agricultural Service and the Office of the U.S. Trade Representative remain concerned, particularly because 2002 trade data showed ex-

tremely low fill rates for the TRQ commodities of most interest to the U.S. industry.

Following announcement of the 2003 allocations, it became clear that problems still exist. The United States again engaged China bilaterally on several occasions, culminating with high-level meetings in Beijing in June of 2003, during which China agreed to take steps to address most of the concerns expressed by the United States.

China followed through, in part, in October of 2003 when it issued new regulations for shipments beginning January 1 of this year. The United States continues to carefully monitor how China enforces these new regulations this year.

And I just want to make one note about the wheat situation and just say that the TRQs that China established are an opportunity. It's not a commitment on China's—part an opportunity to all WTO members, although the United States, of course, expected to export a lot of product under those TRQs.

In marketing year 2003 and 2004, also extending into marketing year 2004 and 2005 for wheat, China has agreed or committed to nearly 2 million metric tonnes of wheat. So the trade is beginning to move in that area. I just wanted to make sure that we had the numbers correct on those exports.

The second area of concern which emerged during China's first year of WTO membership involved implementing regulations related to biotechnology safety testing and labeling. The implementing rules issued by China's Ministry of Agriculture did not provide adequate time for scientific assessment and the issuance of final safety certificates for bureaucratic products, in particular, soybeans.

Following concerted high-level pressure from USTR, FAS and other U.S. Government agencies, China agreed to a temporary solution, effective through the issuance of temporary certificates, initially valid through December of 2003, then extended through September of 2003, and again extended to April of this year.

In the fall of 2003, FAS, USTR and other U.S. Government agencies again urged China to issue final safety certificates in several high level meetings, including the November 2003 trade dialogue, in an effort to ensure that further trade disruptions were avoided. In December 2003, China announced that it would issue final safety certificates by February of 2004.

As each of these deadlines approached, it appeared that U.S. soybean trade with China, our largest trade item to China, would be jeopardized. However, the problem was not exclusively one of arbitrary deadlines. The Government of China appeared to use both biotech and a variety of SPS barriers to restrict soybean trade at key times of the year, such as during Chinese harvests, in order to boost domestic soybean prices.

This approach was used in a variety of product areas but proved most vexing on soybeans, which represent nearly half of our overall agricultural exports to China.

We believe the issue of final safety certificates for soybeans has now been successfully resolved, but other difficulties might lie ahead, as China develops similar regulations for other biotech products, including corn and canola.

USDA, working in tandem with other U.S. Government agencies including the U.S. Department of State and USTR, continues to press our concerns with China both bilaterally and multilaterally with some success, but progress remains incremental. A bilateral U.S.-China trade dialogue has been established, as Mr. Freeman said, to address bilateral trade concerns, and the annual WTO trade policy review mechanism and the regular committee meetings in Geneva permit multilateral review of China's implementation efforts.

The annual USTR report to Congress and the National Trade Estimates Report also serve to highlight China's progress and deficiencies in meeting its WTO obligations in agriculture and other areas, and like my colleagues have expressed, we at USDA stand ready to use all tools available, including dispute settlement at the WTO, should China not comply with its WTO commitments.

So in conclusion, I would like to state that this Department continues to vigorously monitor and enforce China's full compliance with its WTO obligations. Overall, China's compliance efforts in the agricultural sector have produced mixed results in the past year, although progress was achieved in some sensitive areas as biotechnology.

However, many nontariff barriers continue to limit the progress anticipated from China's WTO membership. We have seen that success in this area is measured incrementally and recognize that this will be a lengthy process, given the complexity of the Chinese economy and its regulatory system.

Thank you very much, and I'd be happy to answer any questions. [The statement follows:]

**Prepared Testimony of Ms. Patricia R. Sheikh
Deputy Administrator for International Trade Policy
USDA, Foreign Agricultural Service**

Introduction

Thank you Mr. Chairman, and Members of the Commission, for the opportunity to appear before you again to discuss the significant impact of China's entry into the World Trade Organization (WTO) and how the United States is monitoring and enforcing China's WTO compliance.

The integration of China into the global trade community is expected to offer timely benefits for U.S. agricultural producers, processors, and exporters in one of the world's largest and fastest-growing markets. Expanded export opportunities will directly benefit American farmers as China lowers its tariffs, reduces its trade barriers, and permits U.S. firms to participate in China's economy as China shifts to a rules-based system that is market driven rather than state-policy driven.

Overall Assessment of China's WTO Compliance Record

While it appears that some of these expectations have largely been met, as evidenced by the dramatic growth in demand for such products as soybeans, hides and skins, cotton, and hardwood lumber, China's accession has also been accompanied by a number of non-tariff barriers, non-transparent regulations, and behind-the-scenes interference in trade by China's central government. In essence, we are seeing improved market access, but that access is often inconsistent and erratic, with new trade problems or barriers emerging even as previous ones are resolved.

While problem areas remain, we have clearly made progress on many fronts, as evidenced by some very impressive trade figures. Since China joined the WTO in December 2001, U.S. agricultural exports have more than doubled, from just over \$2 billion in 2002, to a record \$4.1 billion for the first 11 months of 2003. If forest and fishery products are included in the total, then the corresponding rise is from \$2.2 billion to \$4.5 billion. While most of that rise can be accounted for by substantial gains made by soybeans and cotton, both of which reached record levels last year, other commodities, including hides and skins and forest products stand out as

well. With 1.3 billion people—one-fifth of the world's population—China's membership in the WTO gives United States agriculture access to one of the world's largest and fastest growing economies. In the years ahead, we fully expect new export opportunities will emerge for a broad range of U.S. agricultural products, including grains, dairy products, meat, and processed goods.

Key Areas of Concern

But this dramatic growth in trade with China has not been realized without some difficulty. A major threat to U.S. trade interests continues to be the way China periodically veers from its WTO commitments by asserting central controls. Since China's WTO accession two years ago, U.S. agricultural exporters have been confronted with an array of non-tariff trade barriers such as tariff-rate quota administration problems, unscientific sanitary and phytosanitary (SPS) barriers, trade restrictive biotechnology regulations, and complex, confusing licensing requirements. Control and administrative guidance is also evidenced in the form of state trading, quarantine directives, prohibited export subsidies, and threats of retaliation. Many observers within U.S. agriculture believe that the Government of China provides administrative guidance that imports not exceed planned levels.

I would like to highlight for you two areas that were of particular concern for us in 2002 and 2003, and which we continue to monitor. The first issue involves China's commitments related to tariff-rate quotas, or TRQs, on bulk agricultural commodities, including wheat, corn, cotton, and vegetable oils. Since China's State Development and Reform Commission (SDRC) (now known as the National Development and Reform Commission, or NDRC) began implementing these commitments following China's accession, a series of problems served to undermine the market access envisioned by WTO members. SDRC's performance in 2002 improved in certain respects, most notably in completing that year's re-allocations in a timely manner; nevertheless, USDA's Foreign Agricultural Service (FAS) and the Office of the U.S. Trade Representative (USTR) remained concerned, particularly because 2002 trade data showed extremely low fill-rates for the TRQ commodities of most interest to U.S. industry. Following announcement of the 2003 allocations, it became clear that the most serious problems still persisted. The United States again engaged China bilaterally on several occasions, culminating with high-level meetings in Beijing in June 2003, during which China agreed to take steps to address most of the United States' concerns. China followed through in part in October 2003 when it issued new regulations for shipments beginning January 1, 2004. The United States continues to carefully monitor how China enforces its new regulations in 2004.

The second area of concern, which emerged during China's first year of WTO membership, involved implementing regulations related to biotechnology safety, testing, and labeling. The implementing rules, issued by China's Ministry of Agriculture shortly before China's WTO accession, did not provide adequate time for scientific assessment and the issuance of final safety certificates for biotechnology products. These regulations particularly affected soybeans. Following concerted high-level pressure from FAS, USTR, and other U.S. Government agencies, China agreed to a temporary solution effected through the issuance of temporary certificates, good through December 2002. When it became apparent that this extension would not be sufficient, further high-level engagement produced another extension to September 2003, and then again to April 2004. In the fall of 2003, FAS, USTR, and other U.S. Government agencies again urged China to issue final safety certificates in several high-level meetings, including the November 2003 Trade Dialogue, in an effort to ensure that further trade disruptions were avoided. In December 2003, China announced that it would issue final safety certificates by February 2004. As each of these deadlines approached, it appeared that U.S. soybean trade with China, now a more than \$2 billion a year market for U.S. soybean farmers, would be jeopardized. However, the problem was not exclusively one of arbitrary deadlines. The government of China appeared to use both biotech and a variety of SPS barriers to restrict soybean trade at key times of the year, such as during Chinese harvest, in order to boost domestic soybean prices. This approach was used in a variety of product areas, but proved most vexing on soybeans, which represent roughly half of our overall agricultural exports to China. We believe the issue of final safety certificates for soybeans has now been successfully resolved, but other difficulties might lie ahead as China develops similar regulations for other biotech products, including corn and canola. We will work closely with China as they implement food labeling requirements. We will remain closely engaged on these issues in order to avoid any further disruptions in trade.

USDA's Role in Monitoring China's WTO Compliance

USDA, working in tandem with other U. S. Government agencies, including the U.S. Department of State and USTR, continues to press our concerns with China, both bilaterally and multilaterally, with some success, but progress remains incremental. A biannual U.S.-China Trade Dialogue has been established to address bilateral trade concerns, and the annual WTO Trade Policy Review Mechanism and the regular committee meetings in Geneva permit multilateral review of China's implementation efforts. The annual USTR Report to Congress and the National Trade Estimates Report also serve to highlight China's progress and deficiencies in meeting its WTO obligations in agriculture and other areas.

Shortly after China joined the WTO in December 2001, USDA recognized the need to gather expertise from across the department to aid in effectively monitoring China's WTO compliance regarding agriculture. As a result, USDA created two departmental task forces—a USDA-wide task force and a working-level task force within FAS. Six USDA agencies participate in the USDA-wide China task force, which was created in February 2002 and meets quarterly. The FAS-wide task force, which was first convened in March 2002, meets approximately every 4–6 weeks to develop strategies for resolving China compliance issues. We believe that both task forces are effective in sharing information and ensuring that the technical expertise of all relevant units are taken into consideration when responding to a compliance issue. FAS has also added staff in Washington, D.C. and overseas in China to help carry out these efforts.

Conclusion

In conclusion, this Department continues to vigorously monitor and enforce China's full compliance with the trade-liberalizing commitments it made when it joined the WTO two years ago. Overall, China's compliance efforts in the agriculture sector have produced mixed results in the past year, although progress was achieved in some sensitive areas such as biotechnology. China also kept its commitment on tariff reductions, which is in some part responsible for increased sales in 2003. However, many non-tariff barriers continue to limit the progress anticipated from China's WTO membership. We have seen that success in this effort is measured incrementally and recognize that this will be a lengthy process, given the complexity of the Chinese economy and its regulatory system. At the same time we remain convinced that as China more fully complies with its WTO obligations, it will become a more consistent and reliable trading partner.

Panel I—Discussion, Questions and Answers

Co-Chair MULLOY. Commissioner Wessel, you have first the first opportunity to question the witnesses.

Commissioner WESSEL. Thank you, and thank all of you for being here today.

Having worked with several of you in different venues in the past, I know how dedicated you are to your jobs; how important the charge you have to commit yourself to, because America is looking to increase its exports and try and resolve the tricky China problems we've had for many years.

As Senator Dorgan indicated, Congress is looking very carefully at this issue, and unlike many trade agreements in the past, this one is undergoing more scrutiny probably than any other, because of the size of the deficit, the size of the bilateral trade, and the expectations that many people had when we entered into the agreement, the accession agreement.

If each of you could, starting with Mr. Jochum, give us a one-letter answer on how you would grade China's compliance, one of the things that this Commission is charged with is an ongoing benchmarking, if you will, year by year of progress on a variety of U.S.-China bilateral issues, and we'd like to get your views on that if you could.

Mr. JOCHUM. I'm laughing, because I had this conversation with my staff yesterday and nobody would give me an answer.

Commissioner WESSEL. I hope you will give us one.

Mr. JOCHUM. And we debated it pretty vigorously, because obviously, you have heard some of the tradeoffs here. Ag exports have doubled; you know, other things have not happened that we expected.

So, taking all that together, if you're going to force me to give a letter grade, I'm going to say C+.

Mr. SCHRIVER. I had the honor of testifying next to Mr. Freeman last spring, and a similar question was asked, and the answer that Mr. Freeman gave, and I think it's still relevant is it's an incomplete.

It is mixed, some areas better than others, but it's fluid, somewhat dynamic, making progress.

So if you will allow me to give that answer, I will say it's an incomplete.

Mr. FREEMAN. See, that's the difference between assistant secretaries.

Commissioner WESSEL. He didn't say plays well with others, so that's something my kindergartner used to bring back.

Mr. FREEMAN. No, my kids get sort of smiley faces or frowny faces.

I think, as Mr. Schriver says, the best answer you're going to get out of us on that grading question is probably incomplete, although, you know, Jim, steps up to the plate and does the right thing.

I think the reason is that there are so many different commitments that are out there, some of which they are clearly fulfilling to the letter and the spirit of the commitment, others that they are not.

And so, if you look at the 4,000 or so odd commitments, and you try to total them all up, I think you're going to get a variety of different grades. So I think the best answer is incomplete.

Ms. SHEIKH. Since China is moving from a centrally-planned economy to a market-driven economy, and as I stated in my testimony that change has been incremental; if you were to force me to make a grade, I would say a C, but recognizing that a lot of progress has been made; much more remains to be done.

Commissioner WESSEL. I appreciate that.

Commissioner TEUFEL DREYER. Could I just say one thing? And that is, Mr. Freeman, when professors give grades, we recognize that some answers are better than others, and we still give a grade on the exam anyway. So what sort of grade would you give? Some of the answers on this exam are good, and some of the answers are not. But you have to give a grade. Someone has turned in an exam after writing for a period of time.

What would you say?

Mr. FREEMAN. I think that that's the answer—that the exam is still out—they haven't turned it in yet.

How was that?

Commissioner TEUFEL DREYER. A total cop-out, as I think I was implying.

Chairman ROBINSON. I think she's saying she's giving you an F on your answer.

Commissioner WESSEL. Let me, if I can, reclaim my time and ask, regarding a question of resources, the President released his budget earlier this week, and we know with all of the demands on the budget, how difficult this year is going to be.

Are you satisfied where you are? You mentioned, Mr. Jochum, that you have a MAC office in China. How many people are there? Have you seen an internal Commerce Department reallocation of resources to this important area? And have other agencies done something similar?

Mr. JOCHUM. Yes, we have seen a reallocation of existing resources. I think in the President's budget, Commerce had a 1 percent reduction, but most of it came in sort of non-trade areas.

So we feel that with the resources we've been given last year, and hopefully will continue this year if the Congress agrees with the President's budget, we can reallocate resources to address this problem.

One reason we went through the reorganization, which, reorganizations, I guess, are always looked upon skeptically. But my view, being on the Hill and then three-plus years in the Executive Branch is that if you don't have someone who owns a particular issue, it's very likely to fall through the cracks.

So, making someone the Assistant Secretary for Trade Promotion does have some value within the Government.

The answer to your specific question on Market Access and Compliance's China office is that it currently has about 18 employees, which is up from seven just a few years ago showing the, again, reallocation of resources towards that function.

In my own agency, Import Administration, our caseload regarding China has gone up pretty dramatically. And that is why we are now creating an office just to focus on China. There are such unique issues under the dumping laws, we feel that we need to build up expertise and have certain personnel just focus on China as an issue. So that's why we've done that.

So I think these structural changes within the existing budget amounts should help us focus on China better than we have in the past.

Commissioner WESSEL. Any other comments?

Mr. FREEMAN. The difficult thing for us is we are small by design, and it's one of our great strengths. In theory, we're more agile; more nimble; more able to respond quickly and to take action quicker than some of our colleagues.

I will say it's a challenge for our three permanent members that are devoted strictly to China, and I actually devote some of my time to other economies in the region, but again, you know, we work very closely with colleagues from other agencies to try to accomplish what we need to do.

But we do get stretched on China. I was talking to some of your staff on your way out to Geneva, and I was telling them how jealous I was that some of you get to go to Geneva, because we just didn't have the budget to do so.

So there are things that—I think we are getting some additional funding this year to so that should be a big help.

Ms. SHEIKH. At USDA, we were able to add one other person to our country team, our China country team. But because many of

our issues are not only policy driven but technical in nature, it's more effective for us to have a task force within the Department that utilizes the expertise throughout the Department, and that is what we have done to leverage limited resources. And we also have a policy person in our Beijing office overseas.

Commissioner WESSEL. Thank you.

Co-Chair MULLOY. Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

On the question of enforcement, this bears directly on the credibility of the United States to have the political will to do what's necessary get the Chinese to comply within the realm of the promises that they have made. And Mr. Freeman and others can chime in on this one, too.

This is a question of the transitional review mechanism. When we visited Geneva, we were actually shocked by what we were told was going on in terms of the details of the transitional review mechanism. When the WTO agreement was sold to the Congress, the idea of a transitional review mechanism was very much on the marquee, that this was going to be a way for us to monitor Chinese progress in complying with these various agreements and obligations under the accession agreement.

It was going to go for 9 or 10 years. Every year, there was going to be a mechanism for taking a look at it. Now, what we found was yes, there is a transitional review mechanism, and all the committees in Geneva questioned the Chinese as to what they're doing in various areas. The Chinese have taken the position that they don't need to reply in writing to these questions.

But secondly, there seems to be no way of measuring progress, and there is no attempt to say whether there's been any progress from one year to the next. In fact, the record of the debates are simply posted at the end of the year. There is no kind of grading, no roadmap toward real compliance measuring. You all assigned the Chinese some grades. Basically, I thought your grades were the result of what is traditionally now known as grade inflation in this country.

Vice Chairman D'AMATO. But there's not even any grade inflation on the TRM—so, the transitional review mechanism is kind of being pulverized by the Chinese into a kind of benign powder.

We have this mechanism that is supposed to monitor action that is going on, but there's no measuring system. There's no method of determining progress from one year to the next. So then, the question is what is the value of that mechanism, which we thought would be a way to really monitor and determine enforcement.

So the question is, is this broken? Is this transitional review mechanism broken, or did we not understand what was going to happen here? And is there a way now to go back to the concept of measuring progress by these committees annually, mathematically so we get a clear picture over time as to how the Chinese are complying with their obligations?

Mr. FREEMAN. That's an excellent question. Let me just say first with respect to the TRM, we are not satisfied with the way it's been going for a variety of reasons. As you say, the Chinese initially came to us, and they said, you know, this is a discriminatory process, and therefore, the normal rules of the WTO don't apply.

So, therefore, things as basic as responding to questions in writing are out the door. We will respond bilaterally, orally, and answer all of your questions but not in writing.

This is—I mean, I spent a significant amount of my time and energy last year fighting this question, and there was significant angst in Geneva on this issue and significant back and forth and verbal tussling on this issue with the Chinese about the extent to which they needed to comply with the TRM.

We spent a lot of time focusing on the process. We did not get as much help from our multilateral friends as we should have. And at the end of the day, the question was, is this a useful process? The answer is yes, as a way of providing information from China about the extent to which they are complying with their commitments, it is a useful process.

But again, as I said in my opening remarks, it's not the sole bite at the apple. So the question is do we have adequate information about Chinese compliance to make our determination with respect to enforcement or with respect to providing grades or otherwise, and the answer to that is clearly yes.

There is no dearth of information either from the private sector, from our actions, from the monitoring of Commerce in Beijing, from the regular committee process, which is extraordinarily fruitful in providing information, and to which they do provide written answers, there is no dearth of information to provide us the information we need to make enforcement decisions.

So, I think we have a very, very good picture right now of the Chinese compliance.

Is the TRM broken? Let me say it needs to be fixed, and I will say that last year, we got—this last year, things moved slightly better in the right direction in terms of both the smoothness with which it operated and with respect to the level of openness of the Chinese in response to our questions.

I will say that more needs to be done. We were happy that the Europeans and the Japanese and some of our other friends in the WTO began to become more engaged in the TRM and began to actually say yes, this is an important vehicle for us to determine whether China is complying with its WTO commitments.

So we are moving in the right direction. And very frankly, at the end of the TRM, China has said to us, in effect, you know, this is actually a very useful process to us, because you do present us with the questions, and we are able to gather in Geneva or back in Beijing the different agencies together in one room to address these questions you have raised.

So it actually does provide a vehicle for China to start looking at the areas that we have raised and to begin to address them in a sort of interagency way that they have not had before.

Vice Chairman D'AMATO. Thank you. I appreciate that you can cobble together a picture of Chinese compliance in various sectors, but I do think that there is substantial concern in Geneva as to the Chinese behavior in terms of their commitment to the transitional review mechanism. And if the United States is not going to provide an insistence on evaluating and monitoring and grading the Chinese, in a sense, which is what we anticipated, I think that mecha-

nism is in question. And I think some rethinking about our going back to beefing up the mechanism is in order.

Thank you.

Co-Chair MULLOY. Thank you.

Chairman Robinson?

Chairman ROBINSON. Thank you, Mr. Co-Chairman. In the course of looking over a rather formidable briefing book that was prepared for today's hearing, for which I wish to compliment our staff; it was a really Herculean effort, there was something that struck me that I'd like to ask you about.

First, in reading a statement that was made in the course of our background paper, it said as follows: massive continued PR violations in China would seem to beg for dispute settlement treatment. However, academic and legal experts have noted that there are inherent difficulties in contending that the systemic enforcement failings in China constitute violations of WTO commitments. This is especially so given that a relatively complete PR legal framework is in place, and the Government professes interest in stopping violations.

Now, put another way, I'm just trying to get to the issue of whether we're buying into the notion, in effect, that if the Chinese government professes to be working the problem, has a legal framework in place, that these facts alone are enough to deter us from seeking a WTO dispute settlement on what more than one of you have indicated are obvious wholesale property rights violations.

And not to get ahead of your answers here, it begs the question that if we can't move forward in the dispute settlement mechanism on something this egregious, is this mechanism going to be fundamentally viable over time? Whoever's interested in taking a crack at that.

Mr. FREEMAN. That's me again; sorry.

The question with respect to the IPR regime is, is it an effective vehicle to enforce IPR? And China put in place this legal regime in 2001, so we've had roughly two years of experience with it, and to determine whether it's an effective means of enforcement.

I would certainly argue that it's not an effective means of enforcement. And so, the question is, would we, in a WTO panel, if we were to take it, would we be able to convince them that enough time has passed to actually be able to measure whether this is an effective regime?

That's an open question. A more fundamental question is generally, when we take a WTO dispute settlement case, you have unanimity within the industry, the U.S. industry, about their interest in pursuing that as a legal means. And right now, I have to say that we still don't have a lot of unanimity within our industry about what we need to do on IPR in Geneva.

We have a variety of other mechanisms, both carrots and sticks, with which we work with the Chinese, but I will say there is no reticence within USTR about using every means at our disposal to pursue satisfaction.

Co-Chair MULLOY. Thank you.

Commissioner Reinsch?

Co-Chair REINSCH. Thank you.

Mr. Freeman, picking up that theme in a different sector, one of the issues that I think Jim alluded to indirectly was various discriminatory things, one of the most conspicuous of which is their tax on semiconductors, which people tell me is kind of a slam dunk WTO violation.

Are we going to file a complaint?

Mr. FREEMAN. We are actively working that with the Chinese. Let me put it this way: any time that you are preparing for dispute settlement, and we are actively preparing a case, you try to work with your counterparts to resolve it bilaterally.

If the stone wall goes up, and they say no, we think we're within our rights, then, you pursue. If they say, well, let's look at it; let's find ways to work with it, then, you say okay, let's—

Co-Chair REINSCH. So you think you're making progress?

Mr. FREEMAN. I think we're going to give it one last shot, give it one last shot bilaterally before we go to dispute settlement.

Co-Chair REINSCH. When?

Mr. FREEMAN. When are we going to give it one last shot?

Co-Chair REINSCH. Yes, yes.

Mr. FREEMAN. Well, I mean, here's the timetable we're looking at: we have a variety of bilateral discussions between now and April, late April, which is when the Joint Commission on Commerce and Trade meets. I think that's the time frame within which we want to work this issue bilaterally.

Co-Chair REINSCH. Is this an issue where, going back to your criterion that you expressed to Roger, the U.S. industry is all of one view?

Mr. FREEMAN. Happily, they seem to be united on this issue.

Co-Chair REINSCH. Well, then your standard is met. Good.

Mr. JOCHUM, you alluded, I think very constructively, to the standard setting issue and the standard setting problem. One element of that that goes back a long way is working with countries that don't have or have not had adequate standards and working with them to help develop standards, which don't arrive out of whole cloth. They are painstakingly developed. What is the Commerce Department or, for that matter, anybody else in the Government, doing constructively to work with the Chinese to develop the kinds of standards that we would like to have them develop as opposed to some of the other ones you've alluded to?

Mr. JOCHUM. Actually, I appreciate the question, and my written testimony goes into a little bit greater detail. We tend to focus on the litigation.

Co-Chair REINSCH. Well, not much. I looked at your written statement.

Mr. JOCHUM. We tend to focus on the litigation aspect of this, is there a WTO case? Do we bring a WTO case? But Commerce spends a significant amount of resources on technical assistance with the Chinese, and Pat Mulloy worked on this while he was still there, in terms of joint seminars to try to educate the Chinese about standard setting in a number of different areas.

We do have—Secretary Evans launched, in October of last year, when he visited Beijing, a standards initiative in which we will begin meeting more systematically with the Chinese on sector-specific standards. I think one success story, which maybe Pat could

elaborate on, was the fertilizer standards, which the Chinese were putting standards in place that would have affected our fertilizer imports into China. It would have precluded us from a \$700 million market.

I think we fixed that bilaterally, and now, you see the exports going to China. But standards as a sort of nontariff barrier are very significant. We recognize, from the U.S. perspective, that developing countries need our assistance in capacity-building, building up standards that are acceptable international norms that will allow our exports to go. So we do spend a significant amount of time and energy on this issue.

Co-Chair REINSCH. Have the Chinese been receptive to these initiatives?

Mr. JOCHUM. They have. This was actually an agreement between Secretary Evans and his counterpart in October.

Co-Chair REINSCH. Some of your comments earlier referred to non-science based regulations. This sounds like the precautionary principle rearing its ugly head.

That suggests to me that the EU is doing a better job with them on this than we are. Yes? No?

Mr. JOCHUM. I don't think I could evaluate that. I'm not sure if anyone else could?

Charles just said under his breath they're pretty active.

Co-Chair REINSCH. Yes; you want to say it above your breath, Mr. Freeman?

Mr. FREEMAN. I'll put it this way: when there was a period late in 2002 when I went over to discuss soybeans, science-based standards for biotech soybeans, it was very interesting. We met with the Ministry of Agriculture, and the optics of it were great, because they let us into the Sino-German biotech cooperation organization, this thing that the Germans had built for them.

So we actually met within, you know, this German biotech standard setting organization within China, which was—the optics are a little bit goofy, but yes, the Europeans are extremely active on standards.

Co-Chair REINSCH. I'm glad you've caught a hold of that and are working on it.

Last question: are we still having a problem with them insisting on technology transfer as a condition of doing business?

Mr. FREEMAN. I don't think systemically at a national level we are. Certainly, we hear reports, probably the same as you have, from individual companies operating in individual localities about the demand for tech transfer as a cost of doing business there.

Certainly, we don't hear about it systemically from our industries, and we actually have put the word out, please give us anecdotes about it, because it's something that we need to hear more about.

Co-Chair REINSCH. Mr. Schriver, Mr. Jochum, do you want to comment on that or not?

Mr. JOCHUM. I think that's right. I think we've seen it pop up in specific instances, but the systemic nature of it seems to be diminishing.

Mr. SCHRIVER. I agree with that. It's part of the mantra when they talk about the overall trade imbalance, and couldn't we assist

this by loosening our sanctions and restrictions on technology transfer?

But it's raised more in our dialogue as a general point along those lines.

Co-Chair REINSCH. Thank you.

Thank you, Mr. Chairman.

Co-Chair MULLOY. Ms. Sheikh, just to follow up on what was raised by Commissioner Reinsch, did you have anything you wanted to say on that phytosanitary issue? I mean, agriculture, that's your key area, and the precautionary principle?

Ms. SHEIKH. No, I just wanted to add, you asked about helping them out in the SPS sanitary, phytosanitary area. We have done, like Commerce, a lot of technical, capacity-building projects with China to help them in terms of how you notified standards and regulations to the WTO; how you do pest risk assessments which would affect agricultural products and SPS requirements, especially for meat products.

I just wanted to let you know that the full range of technical capacity building goes across, I think, the Executive agencies.

Co-Chair REINSCH. I'm glad; I didn't mean to exclude you. I'm sorry. I was trying to squeeze in my last question, but thank you, Pat.

Co-Chair MULLOY. Yes; Commissioner Dreyer?

Commissioner TEUFEL DREYER. Yes, Ms. Sheikh, thank you very much. That was fascinating. And I have one question for you, which is a question of ignorance on my part, and that is your comment that TRQs are an opportunity, not a commitment.

Could you enlighten me on that just a little?

Ms. SHEIKH. Well, you know, TRQs, they come with quantity levels. But it doesn't mean that a country which is committed to that TRQ has to import that level of product. It means that that opportunity out there is open for all WTO members. It's not just reserved for the United States. Of course, as a large agricultural exporter, in the case of wheat and in the case of the situation that was brought up, we would expect to have a large share of that.

Commissioner TEUFEL DREYER. You mean Senator Dorgan's statement—

Ms. SHEIKH. Yes.

Commissioner TEUFEL DREYER.—about the South China Morning Post story.

So, maybe Long Yongtu was not in, discompliance—I just made up a word—when he said that.

Ms. SHEIKH. I'm not saying he wasn't in compliance. I'm just saying there's an opportunity out there. It has a certain quantity level. All WTO members can take advantage of that export to that product to that country.

Commissioner TEUFEL DREYER. I see.

Ms. SHEIKH. And we think we're well poised to—

Commissioner TEUFEL DREYER. To do that? Okay.

Question for Mr. Schriver: On page 2 of your testimony here, you refer to China's economic transformation contributing to China's political evolution to a more liberal society. Do you really believe that? And if so, on the basis of what facts?

What we see is something different. If you do believe that transformation to a liberal society is happening, what basis are you using compared to what, you know? With Mao Zedong's purges or something like that? Because we see periodic clampdowns on the Internet. We see arrests of dissidents. We see persecution of religion, including torture, and furthermore, it seems to contradict what you say on page 4 of your written statement.

Mr. SCHRIVER. Well, first of all, on questions about human rights, religious freedoms, et cetera, I absolutely agree with you. And, of course, that's well documented in our human rights report, well documented in public statements. The deputy secretary was just in China and spoke publicly about human rights problems within China.

I'll acknowledge that it would be something that's sort of difficult to give an exact and precise measurement to. I think intuitively, I'm comfortable that saying moving toward a rule-based economic system, which involves rule of law and meeting commitments, I think, has the great potential for residual impact and benefits in the political area.

But I will acknowledge that it's a difficult thing to measure, and I'd be pressed to be real explicit on the linkage. But I think as an intuitive matter, I'm comfortable saying it, and I think it's part of the story over time of China's human rights improvement and social improvement over the last 25, 30 years.

Commissioner TEUFEL DREYER. Here, you say serious backsliding.

Mr. SCHRIVER. Yes, ma'am. No, you're absolutely right, and when we talked about backsliding, we're primarily talking about a one-year period. 2003, we believe was a bad year and a year that entailed backsliding in the human rights area.

I think as a general point over time, I'm comfortable making the previous statement about the linkages between economic reform and social and political progress.

Commissioner TEUFEL DREYER. A question for anybody who wishes to answer, do you have any sense that perhaps we have made some improvements, which you all have nicely detailed and some areas that need some work? But would you say that maybe China has reached a plateau, or do you see the potential for considerable improvement here? In other words, they've made some concessions, and that's going to be it, or are you optimistic about our ability to move forward?

Mr. FREEMAN. A plateau, I mean, if you're saying a plateau in terms of compliance with WTO commitments?

Commissioner TEUFEL DREYER. Yes, compliance with commitments; this is a phrase I've heard other people use. That's the reason I bring it up.

Mr. FREEMAN. I have to say that we were worried about a lack of momentum. Momentum seemed to slow down significantly last year. You can argue that there were multiple things that were happening in China that contributed to that slowing down of momentum, but it does trouble us. And again, our primary concern is that China will look at the fact that U.S. businesses are doing reasonably well or foreign businesses are doing reasonably well as a ra-

tionale to continue interfering or intervening in the marketplace to an extent which is not in compliance with WTO commitments.

Commissioner TEUFEL DREYER. Thank you. Anyone else want to add to that?

[No response.]

Commissioner TEUFEL DREYER. Thank you.

Co-Chair MULLOY. Commissioner Becker?

Commissioner BECKER. Thank you, Mr. Chairman.

It's been the policy of past Administrations to consider our trade laws, including safeguard provisions that have been added, as sacred cows, so to speak, that they were untouchable. Yet, at the Doha round, Ambassador Zoellick put our trade laws on the table for negotiation. And this was underscored by Ambassador Zoellick at the Round at the ministerial meetings in Cancun.

My question is can you explain why this turnaround in policy that our trade laws are up for negotiation? There was a Congressional resolution going into Cancun that they were not to be touched, and yet, this was disregarded by the Ambassador.

So we feel that we are at risk now of the only vehicle that we have to protect dumping and countervailing duty problems and safeguards.

Mr. FREEMAN. I suppose that is a question for me. Again, I'm a humble China market access person, so it's difficult for me to speak above my pay grade in that way. But I will say that what was done at Doha was to suggest that we are willing to discuss anything with respect to trade policy to get to a more open, liberalized global trade system that works for U.S. farmers, workers, businessmen, et cetera.

If that includes discussion of trade laws as part of that broader discussion, we're not going to clamp the door on any talks. That doesn't mean that Ambassador Zoellick was sacrificing trade laws as a pawn to try to get to the next step. But a willingness to discuss anything is, I think, part of what happens at WTO and what happens at multilateral talks on this level.

Commissioner BECKER. But up to the Doha Round, they had never been permitted to be put on the table for discussion. This was underscored by Administration after Administration. And once you place something on the table for negotiation, I suspect that's just what you do—you negotiate them.

Mr. JOCHUM. Commissioner Becker, I think to be fair, looking at the last few rounds, and I was there for the tail end of the Uruguay round, changes have been made to the trade laws, probably in each successive round.

They may have been modest, and we can argue about the impact of those, but my understanding is that in all of the last major rounds, certain changes have been made. I think, and I'm not going to speak for Ambassador Zoellick either, but the way I read the Doha declaration is that we have been directed to strengthen our trade laws. And that was certainly reflected in Congress' grant of trade promotion authority to the President.

So the proposals that we've put on the table have really been focused on bringing other countries' trade laws up to ours in terms of transparency, due process and fairness. What we have experi-

enced is that our exporters are becoming increasingly impacted by foreign governments' use of dumping laws against us.

And China is actually a good example. They have become a great user of the trade remedy laws, yet, they don't have the level of transparency that we do at my agency. So I can tell you from my perspective in negotiating in this area, our goal is to improve other countries' systems, because we have the most fair, open, transparent system in the world, so that our exporters are not impacted.

Obviously, we will have to play defense, because the proposals on the table against us get at some of the things that we do in implementing our trade laws. But I would suggest it's somewhat premature to judge where we'll come out on this. The rules negotiations have always been an integral part of any round. I think we're pretty far away from that. But I can tell you, as someone sitting in the chair as the administrator, I certainly understand my direction from the Congress on this issue.

Mr. FREEMAN. And if I can just clarify, speaking for Ambassador Zoellick, you know, he has made clear that whatever happens with the Doha negotiations, there will be no weakening of U.S. trade laws. So, again, Jim's point on discussions of trade laws generally and their impacts is appropriate. But U.S. trade laws are not going to be weakened.

Co-Chair MULLOY. Thank you, Commissioner Becker.

Senator Dorgan, who was here earlier, talked about the size of our bilateral trade deficit with China. And I thought it needed to even be put in a larger context that this is not just a technical discussion, because the United States' total trade deficit probably for last year is approaching \$500 billion.

And in that context, we have to borrow money from abroad to finance those trade deficits. And when people buy our bonds, then, they can have impact on U.S. interest rates when they want to. So this may seem like a really technical discussion, but it has enormous implications for our country, and I think that's why there is such concern in the Congress, and I think out there in the country at large, about these issues.

I wanted to ask—and remember, the Senator talked a little bit about do we make these decisions, do we let political considerations influence how we react to enforcing our rights? And there's a section of our agreement with China, I think it's Section 421—we've talked about our access to the China market, but there's another concern, because China does not have a market-based economy, and because their banking system can lend to state-owned enterprises to build excess capacity, because they don't have to meet a market test, we provided special safeguard provisions in the agreement that if goods were surging into our market that we could deal with that.

The International Trade Commission was given the responsibility, when those charges are made, to investigate and then make recommendations to the President on whether he should exercise that authority and limit the surge of imports.

My understanding is that three times, on three different sectors or particular import sectors, the ITC recommended that the President grant the affected industry that relief. There are another two

cases, I think, in process. But my understanding is that the President denied that relief.

And I'm just wondering what is the rationale for that? Do we need the Chinese cooperation on Korean proliferation, and is that why we don't grant the relief that's recommended by the International Trade Commission? Or what is going on? If you could help us understand that, and I think Mr. Jochum and Mr. Freeman—maybe Mr. Schriver as well, because you've talked about how we work politically with the Chinese on various issues. Help us understand that.

Mr. FREEMAN. Let me make just a general clarification. There have been thus far four decisions by the ITC under 421, two of which, well, three of which, they found market disruption; one of which, they found no market disruption. Two of those cases that have come before the President, he has found that the economic interests of not providing import relief exceeded the interests in providing import relief to the particular industry concerned. There is a third investigation that's pending that he's looking at right now that's actually at USTR and that we're discussing currently.

But again, the issue is not whether or not there are structural problems or banking issues with respect to China. There are a variety of other tools that are available. The antidumping laws continue to be a primary means of enforcing some of those issues with respect to China's unfair trade acts. So 421 doesn't exist in a vacuum. It is a very specific tool, and the President has said he is committed to using that when and if appropriate.

But let me send it over to Randy.

Mr. SCHRIVER. Let me just make a general point, because this does come up from time to time. My Secretary is on record saying this is the best relationship in 30 years, and others say a lot of positive things about the relationship.

This is also an Administration that has addressed differences in a very direct way. This is an Administration that has imposed some of the largest sanctions on China in the history of the relationship for proliferation. This is an Administration that has approved the largest arms sales package to Taiwan. This is an Administration to talk more directly about trade issues; we made a decision on textiles weeks before the Premier of China set foot in the United States; arguably, not the best negotiating tactic for us when we were trying to get some movement from the Chinese on a range of areas.

But when there was a problem or a challenge, no matter what part of the relationship, I think we've addressed it in a very direct way, and we've taken action, and concrete action, even though there may be political fallout.

Co-Chair MULLOY. Well, as I understand, what you've told me is that these decisions, even though recommended by the ITC, you feel the decisions by the President are not being made—when those recommendations come in, they go to some kind of an interagency group, which then advises the President; is that correct, Charles, Mr. Freeman?

Mr. FREEMAN. They go to the USTR to make a determination. We work very closely with our colleagues from other agencies to try to reach a determination. The timetable is very limited.

But I will say that, as Mr. Schriver was suggesting, our relationship with China is such now that we can actually pursue an economic trade issue on one hand and yet pursue other issues with respect to politics or international affairs on another.

I have been in no interagency meetings where the State Department or others have voiced concerns for foreign policy reasons that we shouldn't taking tough action with China on trade issues.

Co-Chair MULLOY. So you feel these are being made on economic grounds.

Mr. FREEMAN. Very much so.

Co-Chair MULLOY. Thank you.

This panel has—there is a lot of interest, so we are going to do another round with those Commissioners who have asked. But we're going to—they're going to be short, shorter than the first round.

So with that, Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

I have two quick questions. One, I want to pursue the IPR question. As I understand it, IPR violations cost our economy, parts of our PR economy, \$2 billion a year. Is that roughly correct?

Mr. FREEMAN. There are a variety of means of looking at it. You can measure it by the full retail value; you can measure it by a variety of costs. I've seen \$2 billion; I've seen higher, and I've seen significantly lower.

Vice Chairman D'AMATO. Well, Everett Dirksen used to say \$1 billion to \$2 billion, we're starting to talk money here. And I think that's still true. Even if there's not unanimity in the industry, clearly, this violation, the level of take for our industry is very, very substantial year in and year out.

If this continues, regardless of whether there may be parts of the industry that are not affected, are we prepared to go forward with a case on China in the context of the WTO and IPR in the foreseeable, near future, let's say this year?

Mr. FREEMAN. I don't want to speculate about what we might do in the WTO or otherwise. But I will say that we are fully prepared to assert all our rights in every forum that we have available to us. This is at our top priority.

Vice Chairman D'AMATO. All right; I think I know the answer, then. I hope that's the right answer.

The second question, this may not be known to even Mr. Jochum; on enforcement, you gave a good presentation on the kinds of activities that we're involved in to try to monitor enforcement. I don't know if you're aware of it, but there is a proposal that is being floated, will probably be introduced in the Senate very shortly, to create a new official level at the Department of Justice, to put into place a trade enforcement official; full-time job to enforce fair trade on the part of the Department of Justice. Senator Hollings is introducing this legislation.

Have you seen this legislation, and does the Administration have a position on creating a full-time enforcement official at a high level in the Department of Justice?

Mr. JOCHUM. Sir, I haven't seen it, and I assume we don't have a position on it. If I could make a comment, though, just on our practice, enforcing the dumping laws, we do find a lot of fraud in

the system and a lot of problems we would like to address but don't currently have the tools. And we've talked to our authorizers about giving us additional tools, but really, it is incumbent upon DOJ or another law enforcement agency to follow up on the problems we find. So——

Vice Chairman D'AMATO. So it might be helpful?

Mr. JOCHUM. Pardon?

Vice Chairman D'AMATO. Might it be helpful? Would you take a look and let us know what you think?

Mr. JOCHUM. Sure.

Vice Chairman D'AMATO. Thank you.

Co-Chair MULLOY. Chairman Robinson?

Chairman ROBINSON. Thank you, Mr. Co-Chairman.

I was intrigued by the comments concerning the balancing act inherent in the relationship, which I think is an art form, between security and trade considerations and whether punches are pulled so to speak on some key trade-related issues such as the currency issue, the hollowing out of our manufacturing sector to advance broader foreign policy and national security goals. I know that you have heard about that on a number of occasions, and you have spoken to it very forthrightly today.

During the Reagan Administration days, I was in a slot where at NSC where it was incumbent on me to try to strike that balance as well. The two areas of the bilateral relationship were commingled, even though—and the interagency process reflected that by necessity. So, I think any Administration, at some level, must cope with this dynamic.

There are some officials who support these trade-related trade-offs because of the perceived value of China's contribution to the war on terror; and resolution of what many of us on this Commission believe is a nuclear crisis on the Korean peninsula. And there is an active debate about whether China is using its full leverage and capabilities to dismantle North Korea's nuclear weapons program, but that is discussion for another day.

But I was intrigued with the view that the Bush Administration has tried to bifurcate these issues so that the trade portfolio is being adjudicated on its own merits; that the perception that there's a good deal of spillover between the two portfolios is perhaps, exaggerated from those outside the Administration. Is that a fair representation of your earlier statements?

Mr. SCHRIVER. I think it is. I mean, this puts us in a position of trying to disprove a negative or something that we don't think is there. You know, prove it.

But again, I think our record in terms of building cooperation while, at the same time, taking action where we feel needed when we have areas of disagreement is pretty strong, and I feel very comfortable with it.

Chairman ROBINSON. And that's been your perception, too, Mr. Freeman?

Mr. FREEMAN. Yes, I think that's absolutely right. I mean, we do pursue economic issues very much on their own merits. I don't have much say in some of the issues that Mr. Schriver deals with, and he sort of leaves us to our own devices in many respects.

Chairman ROBINSON. Thanks so much.

Co-Chair MULLOY. Thank you.
Commissioner Wessel?

Commissioner WESSEL. Let me follow up both on Mr. Robinson's as well as Mr. Mulloy's question, because it relates to some information regarding the 421 cases, and I had followed those fairly closely and been told on one or two of the cases that there was lopsided access, shall we say, to the final stages of adjudication on these issues and that, in fact, domestic parties had limited or no access to many of the decision makers, but representatives of the Chinese government had substantial access.

So I'd argue that we need to, in the future, make sure that we are looking at these issues in the broadest interests of the public and not skew these issues one way or another, and I'm sure with limited time that is an issue we will have to get into at some later date.

Mr. Jochum, I'd like your help after the hearing in the coming days on an issue relating to trade flows, because we've also been looking at disaggregating some of the trade numbers, and it appears that we're getting into a problem of what we call industrial tourists, where our products flow, the access we're receiving in the Chinese market is actually for component products that are being assembled and then being shipped right back to the U.S., increasing our tourism there but decreasing, ultimately, opportunities here in the U.S.

So we would like to work with you on looking at disaggregating some of those trade flows and seeing if we can, even in terms of some of the proprietary business data, what some of the internal trade flows are with companies and whether these are all exports for the Chinese consumer or exports that are coming right back at us.

Mr. JOCHUM. I'd be happy to do that.

Commissioner WESSEL. Thank you.

Co-Chair MULLOY. Thank you.

Commissioner Reinsch?

Co-Chair REINSCH. You've alluded to the enormous bilateral deficit we have with them, yet, their global account is a small surplus I recall; \$20 billion, \$25 billion; I don't know what it will be for 2003.

So obviously, they're buying a lot of stuff from somebody, and they must be running deficits with somebody. Who, and what are they doing that we're not doing?

Mr. FREEMAN. Well, if you look at trade flows generally, you see interesting things that are happening throughout Asia. A lot of—as we've said, I mean, we've had in the last few years a 66 percent increase in our exports to China, while our overall exports have actually decreased to the rest of the world by 10 percent.

So, you know, part of our deficit can be explained in that way, but we've also seen trade flows where our deficit to much of Southeast Asia and East Asia generally has actually decreased by the same amount that the deficit has increased from China. And simultaneously, you've seen a lot of the exports from Southeast Asia, East Asia, that used to come to us go to China.

So what you're seeing is actually a lot of reprocessing value that's being put in in China and then reexported to the U.S. So actually, it's a bit skewed in terms of where—of what the—

Co-Chair REINSCH. That's a good description of what's happening, though it's not really an explanation of why that's happening and why there aren't more things coming directly from here.

Mr. FREEMAN. I think part of it is what's going there. I mean, it's unfinished product in many respects. It's components.

Co-Chair REINSCH. Well, what's going from here?

Mr. FREEMAN. What's going from here?

Co-Chair REINSCH. Raw materials, isn't it?

Mr. FREEMAN. No, actually, our leading export is machinery.

Co-Chair REINSCH. I thought she said a lot of soybeans.

Mr. FREEMAN. Well, our leading export category is machinery. Our leading single export is soybeans. We are selling increasing amounts of agriculture. We're selling a variety of other manufactured goods, but there's a variety of things we're selling.

And, of course, our services trade is increasing significantly.

Co-Chair REINSCH. I think I'd better stop in the interests of efficiency.

Co-Chair MULLOY. I just want one last—we had a hearing on China's exchange rates in September, and we had a number of Members of Congress from both parties who were telling us about the concerns out there in the community about this and in the nation.

And I then attended the hearing that the Banking Committee did with Secretary Snow, who said this is a big issue that we're working on. Can you give us any update on whether, in fact, we're having any success in our efforts to get the Chinese to repeg their currency so that it's not so undervalued vis-à-vis the dollar?

Mr. SCHRIEVER. Well, we haven't had success yet, because they haven't changed their position. But it continues to be raised at the highest levels. Deputy Secretary Armitage raised it with the Premier just last week in China. There was an agreement to set up a technical team that our Treasury Department leads to have discussions with the Chinese on this.

So we're continuing to press, and we're trying to create the mechanisms for addressing this and getting it moving in the right direction, but clearly, they haven't changed their practice yet.

Co-Chair MULLOY. Anyone have anything else to add?

[No response.]

Co-Chair MULLOY. Listen, I cannot thank you enough for your very forthcoming and explicit testimony.

Oh, Commissioner? Sorry.

Commissioner TEUFEL DREYER. I just wanted to ask if you thought revaluing the currency would do any good, because there is, in fact, a school of thought that says it would have the exact opposite effect.

And, Charles, I see you laughing at that one, but because an upwardly revalued yuan would make China's ability to purchase raw materials, which it purchases a great number of, and in dollars, easier, and therefore, the deficit might get worse.

Mr. SCHRIVER. What the President and the Secretary of the Treasury and others have said is that in our view, economies work best when the currency is determined by market forces. Full stop.

The question about how it would impact the trade imbalance and how it would impact manufacturing here, I think economists and people who do this for a living will have a debate. It's part of our discussion, but our discussion on the trade imbalance is much more comprehensive and much more focused on issues such as WTO implementation, as we're talking about today.

Co-Chair MULLOY. And just let me finally comment. You know, we're talking about a rules-based system. There are provisions of both the WTO charter and the IMF charter that say you should not be doing—intervening, you know, to change your currency value. And so, you can make arguments, political, back and forth, but we're looking toward a rule based system, and that's what I think we should be out trying to get compliance with the rules.

So thank you very much, again, this panel; you've been very helpful. We're going to take a five-minute break, and then, we're going to have our next panel.

[Recess.]

PANEL II: CHINA'S COMPLIANCE RECORD

OPENING REMARKS OF CO-CHAIR PATRICK MULLOY

Co-Chair MULLOY. We're very fortunate to have with us on this panel two of the stellar trade lawyers in Washington, who bring a great amount of experience in dealing with the issues that the Commission is looking at, that is, China's WTO's compliance.

Mr. Stewart has done, under contract for this Commission, an evaluation of what those commitments were, and we had that as part of an appendix in our first report. Now, we're two years into it, and today, he's going to help us look at where things have gone in the two years as to what they committed to do and where they are.

Our other witness, Mr. Cassidy, was part of the team at USTR that actually negotiated the bilateral agreement that was part and parcel of bringing China into the WTO, so he can help us look at what USTR and officials directly involved thought they were getting and getting in that agreement and his evaluation of where it has gone to date.

So, thank you very much both for being here. We're going to ask you, if you could, to limit your formal statement to 7 minutes. Your full statement will be in the record. Commissioners have them. And then, we're asking each Commissioner to limit their questioning to five minutes, because we have a full day ahead of us. But thank you very much for being here.

STATEMENT OF TERENCE P. STEWART MANAGING PARTNER, STEWART & STEWART LAW OFFICES

Mr. STEWART. Thank you very much. It's a pleasure to be here this morning.

China's accession to the World Trade Organization at the end of 2001 was and is an historic event and a great experiment. China has much left to do in the coming years to implement its commitments. As we are nearly 26 months since China joined the WTO,

this hearing presents an excellent opportunity to evaluate how well China is meeting its commitments and how well the monitoring process on implementation is proceeding.

First, some good news: many obligations that were to be implemented by China in the first 26 months have been. Indeed, China has generally implemented in a timely manner tariff reduction commitments on industrial and agricultural goods, certainly one of the important obligations assumed by China in joining the WTO.

Similarly, China has revised many laws and regulations to mirror WTO obligations. Governments and companies report some improvements in enforcement of intellectual property rights, although piracy obviously remains rampant. There are also improvements in transparency, even if not to the level desired or committed to by China.

However, many important obligations have not been met or have been met with significant delays. The problems that various parts of U.S. agriculture have faced with China's TRQ administration are one example of delay in implementing obligations important to U.S. exporters. Similarly, China was at least two years in arrears on its commitment to open auto financing and has received significant criticism for its handling of auto and auto part quotas, although there are recent positive developments in all of these areas.

Financial service providers and other service sectors have found obligations being implemented late, if at all, and with restrictions not encountered in other countries and which effectively reduce the value of the market opening promised by China. Finally, trading rights remain severely limited in many circumstances, despite the importance of these commitments to all WTO members during China's accession negotiations. For example, China committed to giving full trading rights to joint venture enterprises with majority share foreign investment two years after accession, that is, by this past December 11, a deadline that has not been met.

Instead, eligibility for trading rights in China continues to be limited by pre-accession conditions such as requirements related to minimum registered capital, import and export levels and prior international trade experience. China's problems with compliance seem to fit into several categories. Some reflect the difficulties with meeting the time line commitment and not a lack of desire or willingness to make the changes. Some reflect difficulties within China in getting ministries to make changes agreed to by the government in their areas of control. TRQ administration problems and the delays and additional unwarranted burdens imposed in financial services would be two examples.

Still other problems reflect infrastructure needs or longer term educational or normative behavior change needs: curtailment of piracy of intellectual property being the most obvious example. In addition to implementation problems encountered to date, the Commission should be aware that China has aggressively worked to undermine the utility of provisions added to its accession protocol which were designed to ensure multilateral supervision of timely compliance or to permit other WTO members to exercise rights to limit imports from China during a transition period while China was making further modifications to its trading system to become more WTO compatible.

Such actions by China significantly undermine the value of the commitments undertaken by China and rights secured by China's trading partners. Let's look at Article 18 of the Chinese protocol as one example. Multilateral supervision of China's implementation of its commitments is provided by Article 18 of China's protocol of accession to the WTO, which requires an annual review of China's progress in implementing various obligations for 8 years and a final review in the 10th year after accession by each standing committee and by the councils of the WTO. Article 18 also envisions that recommendations could be made to China as to how to improve its compliance.

China has worked hard to lower expectations of the Article 18 process. Specifically, it refused to permit the Article 18 process to start early by blocking agendas and meetings where the TRM issue was raised. China refused to respond to questions from members in writing, the normal WTO procedure.

Finally, China ensured that the committee and council reports generated were limited to an identification of issues raised and did not address any recommendations. These same types of problems are true for other obligations, including the transitional safeguard measure and the special textile safeguard provisions. China has worked very hard in the United States to encourage the Administration not to take advantage of these rights enjoyed by all WTO members following China's accession, lobbying the Administration hard against their use in early cases.

In addition to U.S. efforts through the WTO to encourage China's WTO compliance, the U.S. has devoted significant resources to monitoring compliance and working with the Chinese government on a bilateral basis, as you heard earlier today. Some of these efforts are reviewed in the U.S. Trade Representative's 2003 report. The U.S. also works with other WTO members who have interests in particular issues, and of course, they receive important input from the U.S. business community here and in China.

Before closing, I would note that currency misalignment is an issue potentially addressed through the WTO obligations undertaken by China which is not currently actively reviewed within the WTO. China's currency is viewed by many as undervalued, with estimates of undervaluation ranging from 15 to 40 percent. The U.S. Government needs to address this urgent problem beyond the initial discussions conducted with Chinese officials. Use of domestic laws and the WTO may be appropriate options.

In conclusion, given the disappointing results of 2003 as noted in the USTR compliance report, I think one would have to give China a grade of no better than C in meeting its WTO commitments to date and even lower grades on some important subcategories of obligations.

China has, in many areas, made a good faith effort to reform its laws and regulations, in implementing changes to its tariffs and in transforming its trade practices to GATT/WTO requirements. But the record of the past two years shows that there have been and still are significant problems with China's implementation of its full set of WTO commitments, and as USTR itself noted, China's shortcomings this past year cannot be attributed simply to startup difficulties.

China needs to and must do better. Thank you very much.
 Co-Chair MULLOY. Thank you, Mr. Stewart.
 Mr. Cassidy?
 [The statement follows:]

**Prepared Statement of Terence P. Stewart, Esq.
 Managing Partner, Law Offices of Stewart and Stewart**

Members of the Commission, good morning. China's accession to the World Trade Organization at the end of 2001 was and is an historic event and a great experiment. Because China is a huge country, with a very rapidly expanding economic base and an economy which continues to reflect significant state involvement in decisions of resource allocation, there was no certainty at the time of accession that China's economic system would mesh well with the World Trade Organization rules and other trading partners' generally market-oriented economies. Indeed, in the history of the GATT, and now World Trade Organization, never has a country of such trading importance been admitted with a system that was still so far from conformance with GATT/WTO norms. China has worked hard to make an enormous array of changes to its legal and regulatory system before accession and had much work to do after accession if membership was to present the market opportunities within China that trading partners expected.

My firm prepared an analysis in 2002 for this Commission of the benchmark commitments China undertook as part of its accession to the WTO and provided a very preliminary evaluation of how the early months of accession were going in terms of compliance. Today we are nearly twenty-six months since China became a member of the WTO, and it may be possible to form a better picture of the level of compliance achieved to date and the problems that remain ahead. My firm is in the midst of preparing an evaluation of the level of compliance to date for the Commission. What follows are some preliminary impressions based on our analysis to date.

First, I want to be clear that many obligations that were to have been implemented by now have been. Indeed, China has generally implemented in a timely manner tariff reduction commitments, certainly one of the important obligations assumed by China in joining the WTO. Similarly, China has revised many laws and regulations to mirror WTO obligations—obviously welcome developments. Governments and companies report some improvements in enforcement of intellectual property rights (although piracy remains rampant). There are also improvements in transparency even if not to the level desired or committed to by China.

Problems with Compliance

However, many other obligations have not been met or have been met with significant delays:

For example, the problems that various parts of U.S. agriculture have faced with China's TRQ administration are one example of failure and/or delay in implementing obligations important to U.S. exporters.

Similarly, China is at least two years in arrears on its commitment to open auto financing and has received significant criticism for its handling of auto and auto parts limits consistent with commitments undertaken, although there are recent positive developments in all these areas.

Financial service providers (and other service sectors) have found obligations being implemented late, if at all, and with restrictions not encountered in other countries and which effectively reduce the value of the market opening promised by China.

And trading rights—which were to have been significantly liberalized by now and to have become universal by the end of 2004—remain severely limited in many circumstances despite the importance of these commitments to all WTO members during China's accession negotiations. China committed to giving full trading rights to joint-venture enterprises with majority share foreign-investment two years after accession, that is, by December 11, 2003. China, however, failed to meet this deadline. Instead, as USTR reported in its 2003 compliance report, eligibility for trading rights in China continues to be limited by pre-accession conditions such as requirements related to minimum registered capital, import levels, export levels and prior international trade experience. These types of conditions on trading rights were common before accession but were precisely the types of restrictions that were to have been eliminated as part of China's accession commitments.

The 2003 compliance report issued by the U.S. Trade Representative found that China's WTO implementation efforts failed to meet expectations in many important areas. In particular, USTR stated that 2003:

proved to be a year in which China's WTO implementation efforts lost a significant amount of momentum. In a number of different sectors, including some key sectors of economic importance to the United States, China fell far short of implementing its WTO commitments, offsetting many of the gains made in other areas. Indeed, institutionalization of market mechanisms still remains incomplete, and intervention by Chinese government officials in the market is common. In many instances, China has sought to deflect attention from its inadequate implementation of required systemic changes by managing trade in such a way as to temporarily increase affected imports from vocal trading partners, such as the United States.

USTR, 2003 Report to Congress on China's WTO Compliance (December 2003) at 4.

The 2003 report identifies the areas where China failed to meet its WTO commitments or has imposed new or additional trade barriers, including the following areas of importance to U.S. interests:

- Agriculture (TRQs on bulk agricultural commodities—problems with sub-quotas, import licensing, allocation)
- TRQ on fertilizer
- Services (capitalization and other requirements that exceed international norms in such service sectors as banking, insurance, construction/engineering, and express courier)
- Enforcement of intellectual property rights (continued IPR infringement affecting products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, consumer goods, electrical equipment, automotive parts and industrial products)
- Trading rights (continued restrictions)
- Distribution rights (e.g., restrictions on ability to sell imported and China-made autos from same location)
- SPS (new requirements on seafood; ban on soybeans)
- Customs (continued use of inaccurate valuation methods)
- VAT (discriminatory tax on semiconductors, fertilizer, and other products favors domestic producers over U.S. exports)
- Telecom standards (e.g., requirement to use two mandatory encryption standards in wireless networks different from internationally-recognized standard used by U.S. companies)
- China Compulsory Certification (CCC) mark (China safety certification process is duplicative and discriminatory)
- Transparency (uncertainty and lack of uniformity is common; limited opportunity to comment on proposed laws and regulations)

Problems with compliance seem to fit into several categories.

Some problems appear to reflect simply the difficulties with meeting the timeline commitment and not a lack of desire or willingness to make the changes. Delays of a few months or longer in matters that have ultimately been complied with would be examples.

Other problems appear to reflect internal problems within the Chinese government in getting ministries to make changes agreed to by the government in their areas of control. Problems in TRQ administration in agriculture and the delays and additional unwarranted burdens imposed in the financial services areas would be two typical examples.

Still other problems reflect infrastructure needs or longer-term educational or normative behavior change needs—intellectual piracy curtailment being the most obvious example. While the local authorities and courts appear capable of handling pirated product where company logos or trademarks are involved, there is much less confidence in the ability of the court system to construe IP laws in ways consistent with norms in other countries, as major auto companies are discovering when product designs are stolen or knocked off. For example, the Financial Times reported that a number of auto companies, including Nissan, Toyota, General Motors, and Volkswagen, have experienced trademark infringement and theft of auto designs by Chinese companies. *See Nissan alleges Chinese IP theft*, Financial Times, November 28, 2003.

At the same time, China has aggressively worked to undermine the utility of provisions added to its accession protocol which were designed to ensure multilateral supervision of timely compliance or to permit other WTO members to exercise rights to limit imports from China during a transition period while China was making further modifications to its trading system to become more WTO compatible. Such ac-

tions by China do not amount to problems with “compliance” as that term would normally be considered, but they nonetheless significantly undermine the value of the commitments undertaken by China and rights secured by China’s trading partners. Let’s examine these two topics separately.

Article 18—Transitional Review Mechanism

On the issue of multilateral supervision of China’s implementation of its commitments, Article 18 of China’s protocol of accession to the WTO requires an annual review for eight years and a final review in the 10th year after accession by each standing committee and by the three councils of the WTO (Goods, Services, TRIPs) and by the General Council of China’s progress in implementing various obligations. Article 18 envisions that recommendations could be made. This obligation mirrors the obligation Congress sought to have included in China’s protocol of accession in 2000 in agreeing to grant China most-favored nation status under U.S. law.

The U.S., EU, Japan and other countries considered the obligation would be robust, meaning that WTO members would be able to forward questions in advance, receive written responses and submit follow-up questions for similar treatment. This is normal WTO practice in all of the Committees for other reporting obligations members have.

Other members (including the U.S.) were also interested in setting up a schedule early in China’s membership to ensure the process would be meaningful and would permit a thorough evaluation. China refused to permit the Article 18 process to go beyond the literal language of the protocol. Since there was no timeline identified, China would not agree to early meetings and, in fact, blocked agendas being issued or meetings being held where the topic of the Article 18 TRM was included. I am informed that such blocking action was unprecedented within the WTO.

China took the position that Article 18 did not mention written answers and so has refused to provide written responses or permit the process to be one where a series of Q&As takes place to provide better transparency on the operation of various Chinese programs.

Because the WTO works on consensus, China has not agreed to have any document originate from the various standing committees or the councils that goes beyond a review of topics identified. No conclusions or recommendations have been made.

So strident was China’s behavior in 2002 that they effectively lowered expectations of WTO members for the Article 18 process, as can be seen in the various 2003 TRM committee reports and notes. It is understood that while China continues to refuse to provide answers in writing in advance of meetings of the TRM, it did regularly provide a copy of the statement of their spokesperson at the end of the committee meeting this past year.

Because the Article 18 process is just one of the ways member nations work with China to understand developments in the country and to address problems that may arise, it is hard to characterize the lowering of expectations in the Article 18 process as critical for China’s compliance effort. Nevertheless, it is an important example of concerted effort by China to minimize an obligation undertaken. The same is true for other such obligations.

Special China Safeguard Measures: Textile and Product-Specific

Specifically, the protocol of accession permits countries to take a safeguard action against imports from China alone where market disruption is caused by increased imports during the transition of China to full implementation of all obligations. In addition, countries were allowed to have special textile safeguard provisions till 2008 to address import surges that cause market disruption. These were important provisions in the U.S. for Congress and many industries concerned about expanded competition with China when its economic system was still so dissimilar to that of the U.S. They were important to other countries as well.

Indeed, in 2000, when it enacted Section 421 as part of the bill granting permanent normal trade relations with China, Congress indicated that Section 421 should be applied vigorously to address import surges from China. The rationale behind Section 421 was that U.S. industries should not lose jobs to competition from Chinese imports at a time when China was adjusting to WTO obligations. Moreover, Congress expressly stated that “if the ITC makes an affirmative determination on market disruption, there would be a presumption in favor of providing relief.” See House Report No. 106-632, 106th Cong., 2d Sess. 18 (May 24, 2000). Further, Congress said that Section 421 established “clear standards for the application of Presidential discretion in providing relief to injured industries and workers,” and that the presumption in favor of relief could be overcome “only if the President finds that providing relief would have an adverse impact on the United States economy clearly

greater than the benefits of such action, or, in extraordinary cases, that such action would cause serious harm to the national security of the United States." *Id.*

China has worked very hard in the United States to encourage the U.S. not to take advantage of these rights enjoyed by all WTO members following China's accession. Indeed, China lobbied heavily during early Section 421 cases (Section 421 of the Trade Act of 1974, as amended, implements U.S. rights to take selective safeguard action against China) and lobbied the Administration against using the textile safeguard provisions adopted by the U.S. after China's accession.

For example, in the first Section 421 case involving pedestal actuators, press stories reported that the Chinese government conducted an intense and wide ranging lobbying campaign to block relief. China's Vice-Minister for Trade, Long Yongtu, came to Washington and met with Commerce Department officials in December 2002, arguing that the use of Section 421 would undermine China's market access to the United States. The Commerce Department's General Counsel, Theodore Kassinger, told Minister Yongtu that President Bush would take account of China's concerns in deciding on a remedy. See *Chinese Official Complains about China-Specific Safeguards*, ChinaTradeExtra.com, posted December 6, 2002. In addition, a press report indicated that some Administration officials believed imposition of a safeguard measure on Chinese imports could have negative political consequences in that "a decision to impose the ITC remedy could lead to increased use of the China-specific safeguard, which could further complicate the bilateral trade relationship." See *U.S. Holds Door Open to Settlement in First China-Specific Safeguard Case*, Inside U.S.-China Trade, November 13, 2002.

After the President denied relief in the second Section 421 case concerning steel wire garment hangers, an observer commented that one possible view of the President's action was that it was "an overtly political decision by the President made under pressure from the Chinese government and a signal that this Administration has no intention of ever granting relief under Section 421." See Eliza Patterson, *The U.S. President, Once Again, Rejects Import Sanctions Against China*, ASIL Insights (May 2003) (available at the website of the American Society of International Law: www.asil.org.insights/insigh106.htm).

The result has been that the first two cases under Section 421 were denied relief by the President, even though the purpose of the statute and Congressional intent were that relief would be reasonably available. Few involved doubt the effect of Chinese government efforts in preventing this important U.S. law from serving its purpose.

These important U.S. laws have been further handicapped either by delay in adopting implementing regulations (textile safeguard regulations were not adopted until 2003) and by the imposition of requirements on petitioning parties in Section 421 cases that impose burdens not actually required by the law (adjustment plans are irrelevant since Section 421 is meant to see that the U.S. doesn't lose manufacturing jobs during China's transition to a more market oriented economy) or impose data requirements on petitioners that effectively deny the opportunity to seek relief to a wide range of U.S. industries.

With respect to the textile safeguard, the U.S. administering agency, the Committee for the Implementation of Textile Agreements (CITA) took almost 17 months to issue procedural rules detailing how petitions should be filed and the type of information that should be submitted. During those 17 months, the U.S. textile industry repeatedly urged CITA to act expeditiously and even filed a number of petitions before CITA issued its rules. CITA did not act on these petitions and the U.S. industry had to refile its petitions after CITA issued its procedural rules. CITA's delay was costly to the U.S. textile industry. According to the American Textile Manufacturers Institute, in the period before CITA issued its regulations, imports of Chinese textile and apparel products increased more than 165 percent, 50 U.S. textile plants closed, and some 39,000 textile workers lost their jobs.

With respect Section 421 cases, the ITC's rules have burdened U.S. industries seeking relief by requiring onerous data submission and by requiring submission of adjustment plans. These latter requirements are not warranted in the case of the special China safeguard because, unlike regular safeguard actions where the U.S. industry is seeking temporary relief from, and time to adjust to, increased global imports, the special China safeguard is intended to address the effect of import surges from China only during the transitional period in which China has not fully implemented all of its WTO commitments and is still operating as a less-than-full-market economy. The special safeguard was negotiated as a form of compensation for allowing China to enter the WTO before it had fully complied with or conformed to all WTO obligations. The standards for imposing a special China safeguard were deliberately set lower than a regular safeguard because it was intended that affected industries should not be burdened with onerous standards. Moreover, adjust-

ment plans are not relevant to a special China safeguard. Congress stated that Section 421 was intended to replace Section 406 (addressing market disruption caused by imports from communist countries) and that the Section 421 procedures were modeled after Section 406. *See* House Report No. 106–632, 106th Cong., 2d Sess. 16 (May 24, 2000). Section 406 actions do not require the submission of industry adjustment plans. *See* 19 U.S.C. § 2436.

Bilateral Relationship

It should be noted that, in addition to U.S. efforts through the WTO to encourage China's WTO compliance, the U.S. has maintained an active series of bilateral discussions with China throughout the past two years. USTR's 2003 report (at 5) highlights these bilateral efforts and stresses their importance given China's shortfalls in meeting WTO commitments.

- As the slowdown in China's WTO implementation efforts became evident in 2003, the Administration stepped up its efforts to engage senior Chinese leaders. Over the course 2003, President Bush emphasized the importance of China's WTO obligations in meetings with his counterpart, Hu Jintao, and with China's Premier, Wen Jiabao.
- USTR Zoellick made two separate visits to China for talks on WTO implementation matters with Premier Wen and with Vice Premier Wu Yi.
- USTR Zoellick raised U.S. concerns throughout the year with his Ministry of Commerce (MOFCOM) counterpart, including most recently at the October 2003 APEC meetings in Thailand.
- The Secretaries of Commerce and Treasury made their own trips to China carrying the message that China's WTO implementation was a matter of the highest priority.
- Sub-cabinet officials from various U.S. economic and trade agencies also met with their Chinese counterparts in China, Washington and Geneva to work through areas of concern, including WTO implementation issues, on numerous other occasions.
- In 2003, the Administration established the "Trade Dialogue", a sub-cabinet dialogue on WTO compliance and other trade matters that brings together U.S. economic and trade agencies and various Chinese ministries and agencies with a role in China's WTO implementation. Trade Dialogue meetings were convened twice in 2003 (February and November). The Trade Dialogue meetings were used to communicate specific trade concerns and served as an early warning mechanism for emerging trade disputes.

Other Important Issues—Undervaluation of Chinese Currency

There are some significant trade problems, such as currency misalignment, that are not directly addressed by commitments in China's accession agreement but over which the WTO has some possible oversight. Currency misalignment is a problem that can create trade distortions in international trade because misalignment results in misallocation of economic resources and undermines stability. Undervalued currencies, in particular, can produce false market signals—making it appear that industries in the country with an undervalued currency are more competitive than they actually are, leading to overexpansion of production and export flooding by particular products.

Of late, China has been singled out as a country with an undervalued currency that has had substantial negative effects on trade. Economists have observed that China manipulates its currency through large and persistent central bank purchases of dollars and other foreign currencies, resulting in the RMB being undervalued by about 40 percent. They have estimated that the effect of this undervaluation is that the U.S. trade deficit is about \$100 billion larger than it would otherwise be, which translates into one million fewer U.S. jobs in manufacturing. *See Chinese Currency Manipulation and the U.S. Trade Deficit*, Statement Before the U.S.-China Economic and Security Review Commission by Ernest H. Preeg, Senior Fellow in Trade and Productivity, Manufacturers Alliance/MAPI, September 25, 2003.

The current concern about China's undervalued currency and its effects on U.S. manufacturing and increased imports has led to a number of proposals presently introduced in Congress to address this problem. For example, a bill introduced by Senator Schumer would impose a 27.5% additional rate of duty on Chinese imports.

The U.S. Government needs to address this urgent problem beyond the initial discussions conducted with Chinese officials.

Conclusion

The Commission asked for an overall assessment of China's record of compliance to date with its WTO obligations and asked what grade would one give it. Given the disappointing results of 2003 as noted in the USTR compliance report, I think one would have to give China a grade of no better than "C" in meeting its WTO commitments. It must be acknowledged that China has, in many areas, made a good faith effort in reforming its laws and regulations, in implementing changes to its tariffs, and in transforming its trade practices to GATT/WTO requirements, but the record of the past two years shows that there have been, and are still, significant problems with China's implementation of its WTO commitments. And, as USTR itself noted, China's shortcomings in 2003 cannot be attributed simply to start-up difficulties. China needs to, and must, do better.

Thank you for the opportunity to appear today. I would be pleased to respond to questions.

**STATEMENT OF ROBERT B. CASSIDY
DIRECTOR, INTERNATIONAL TRADE AND SERVICES,
COLLIER SHANNON SCOTT, LLC**

Mr. CASSIDY. Thank you Mr. Chairman, Members of the Commission. Good afternoon, and thank you for inviting me here to speak on China's compliance with its WTO obligations and U.S. monitoring efforts. I'm particularly pleased to do this because of the large role that I had in negotiating the original market access agreement, which then became the basis for the WTO accession agreement.

I use that as a starting point for many reasons. It was a carefully-crafted set of commitments that met U.S. objectives, but it also had a number of rights and obligations that—and checks and balances, if you will, that were designed to ensure that it would be implemented effectively—that the United States and China would both benefit from the agreement.

And why were those checks and balances needed? Simply put, the integration of a nonmarket economy country this size into the trading system, into a system that was designed and depended upon the efficient operation of markets was a challenge of monumental proportions that had never been experienced before or since.

Mr. Stewart has given you a list in his testimony of all of the various areas of deficiencies, and I think speakers today will give you a complete accounting of what those deficiencies are. So what I would like to do is take a different tack. I would like to look at what are some of the deficiencies in the agreement, areas, for example, where the checks and balances have not been used and then, other areas where I think, in my honest opinion that the agreement didn't go far enough in specifying what was necessary.

Now, let me say, the list of deficiencies is pretty extensive. But I think that one conclusion I have drawn is that China is becoming more sophisticated in using regulations to restrict access to foreign-made goods and services. Given China's success in limiting market access, speaking as a negotiator, we should continue to expect them to do the same unless there are some consequences, and that is where I think the checks and balances come in.

The ones that I would like to talk to you about today or that you asked me to talk about are the trade review mechanisms, the safeguard mechanisms and WTO dispute resolution. The TRM system, the trade review mechanism, was relegated to a pro forma session

where individual countries complained about China's failure to implement its commitments.

Quite frankly, it is a far cry from what was originally intended and expected by WTO members when China entered into the WTO. The original purpose of the TRM was to provide guidance and, when necessary, to apply pressure on China to implement its WTO obligations. Because the WTO process operates on a consensus basis, China has been able to prevent any substantive review of WTO members of the consistency of its laws and regulations to the WTO obligations.

In effect, China has laid down a gauntlet that the TRM process will not be used as a mechanism to force China into revising its laws to conform with the expectations of WTO members; in effect, China has challenged WTO members to use dispute resolution as a balancing mechanism, and to date, WTO members have not risen to that challenge.

And the reasons are understandable and legion. For small economies, for example, there is a concern that Chinese retaliation is real, especially because of the narrow range of traded goods leaves them vulnerable to Chinese pressure and unofficial sanctions.

For the larger economies such as the United States, the EU and Japan, the diversity of views within each industry makes WTO challenge difficult. Many companies are invested in China and thus fear using dispute resolution because of the retaliation that will result.

Commercial and foreign policy concerns also prevent the United States from initiating a case. The most likely one is the VAT-rebate case that you mentioned earlier today. Deputy USTR Shiner has indicated that the United States is close to making a decision on such a case.

According to the press reports, Ambassador Shiner has said that if current bilateral consultations fail to break the current impasse, the United States may seek further consultations in the WTO. Essentially, consultations beget consultations but rarely dispute resolution.

The failure of the WTO members to use the dispute settlement process, the binding arbitration process that was negotiated, means that China has a carte blanche to decide how it implements its WTO obligations.

Now, on product specific safeguards, there are two product safeguard mechanisms, one dealing with textiles and one dealing with all other products, including textiles. What we're seeing in the textile agreement, a measure that was undertaken just recently, is that indeed, it's having the effect that we had expected it would have. The United States, with urging from producers, is looking at exploring different options that would create a more orderly transition for China. U.S. producers have proposed that China and the United States negotiate broader range of solutions in exchange for avoiding future textile safeguards, and indeed, the EU now is considering bringing a safeguard case on textiles.

Conversely, the product-specific safeguard, the our section 421 law has not been used by the United States or WTO members have used. There have been five cases. Three cases that have gone through the ITC. In two cases, the ITC found in the affirmative;

one against. The current case, actually brought by our firm, Collier Shannon Scott, is currently under review by the trade review system within USTR, the TPSC process, and a recommendation will be made to the President soon.

But I would argue that the failure to use these mechanisms is essentially saying to China that we're not going to use the checks and balances. They're not really part of the landscape. And so, China once again can say and do whatever it wants and not have to be held accountable.

Now I would say that the 421 situation is designed somewhat differently than the other mechanisms, because it is designed specifically to deal with situations where China is actually implementing its concessions, but the effect of China's nonmarket economy is still flooding the market and causing market disruptions. In short, adjustments need to be made in China in order to bring their economy more into market norms.

There are two areas that I think that the agreement was somewhat deficient. A student asked me what I would renegotiate given the opportunity again. One of them is that we should have dealt with internal barriers to trade, something like an intra-provincial law that would remove those barriers to trade.

China has enormous barriers to trade among the provinces and even by the cities. There are shakedown; there are restrictions on loading and unloading freight that creates barriers. There are inefficiencies of the rail and road transportation; all of these are creating barriers to entry, and, in fact, the Chamber of Commerce in Shanghai has estimated that the cost of distributing goods in China is 16 percent, and that compares to about 4 percent in OECD countries.

So there are significant costs, and had we had an opportunity or even thought of it at the time, I think that would have been one of the areas, and I would urge that the Commission look at suggesting that we look beyond the confines of the agreement itself and look into other ways where deficiencies in the agreement are essentially nullifying and impairing the agreement.

The other area that I would urge the Commission to look at is exchange rates. All experts agree that the exchange rate is undervalued. The Economist's Big Mac index—says about 56 percent; the Fair Currency Alliance has estimated about 40 percent. In short, China is amassing huge reserves, and I understand that they have grown to over \$400 billion. This is 30 percent of their GDP.

Our trade deficit with China is essentially being used—the Chinese government has indicated that what it is going to do is take these reserves and underwrite the banking system. So what we see is that the Chinese government is using the reserves to underwrite the banking system, which, in turn, is indirectly supporting the state-owned enterprises. And I find that there's a certain amount of irony here, in that WTO members are not using the 421 mechanism—the safeguard mechanism—to provide relief to their own domestic industries that are suffering from market disruption caused by the Chinese overcapacity, in turn that was financed by the state-owned banks.

China's currency manipulation, simply put, puts a burden on manufacturers. As the dollar depreciates against other currencies,

the exchange rate with the yuan never changes, contributing to a continuing rise in the deficit with China. The Fair Currency Alliance has hired our firm to prepare a 301 case on currency manipulation, and I think the FCA's hope is that the Administration, by accepting this case, will gain leverage with China to substantially revalue the yuan and bring its currency into alignment with economic conditions.

I think the examples of the peso crisis, the Asia financial crisis, have taught us that failure to address unsustainable exchange rate alignments will create global financial crises unless addressed early and significantly.

In summary, any examination of the implementation of China's agreement to join the WTO and the monitoring of those commitments should encompass not only a detailed assessment of the specific commitments, but equally important, it should encompass how the checks and balances of the agreement have been exercised.

In the absence of challenges in the form of dispute resolution and safeguard actions on the part of WTO members, China will not be compelled to use the trade review mechanisms to resolve disputes or to implement its obligations in the rigorous manner that Congress intended.

In addition, the Commission should extend the examination beyond the specifics of the accession agreement itself to encompass measures in China that effectively nullify or impair the benefits that the United States expected. Chinese internal barriers to commerce and China's currency manipulation should be the highest priority of the Commission.

[The statement follows:]

**Prepared Statement of Robert B. Cassidy
Director, International Trade and Services, Collier Shannon Scott**

Members of Commission, good morning and thank you for inviting me to testify today on China's compliance with its obligations under the World Trade Organization (WTO) and U.S. monitoring efforts. I am particularly pleased to have the opportunity to evaluate the effectiveness of an agreement that I had such a large role in negotiating. As I compare the present situation with the past, the dynamics of that assessment are still very much like the dynamics of the negotiations themselves—full of extremes. There are those who see China's accession as a panacea for economic woes and those who see China as the pariah of the trading system. Your hearing today may demonstrate that China is both.

The issue of China's compliance with its WTO obligations must be put into its proper perspective. Although the United States led those efforts and Ambassador Barshefsky was, in my view, the driving force in that achievement, China's obligations are global commitments. And thus, there are global responsibilities that we share with other WTO members. Far too often, the United States is called upon to shoulder the burden of leadership on global trade issues alone. But in the case of China's WTO compliance, success will only be achieved when the United States and other WTO members work together. So the comments that I am making today apply equally to other WTO members, and as long as those nations depend on the United States to enforce China's commitments, the global trading system will be worse off. Four years have transpired since we concluded the market access agreement between the United States and China, the turning point in China's 15-year journey to join the WTO. Although long and difficult negotiations continued until China joined the WTO in December of 2001, those market access commitments were the building blocks for China's accession agreement. I reference that agreement because it represented a carefully conceived and executed set of commitments that, even then, embodied a combination of checks and balances between rights and obligations, designed to ensure that both China and the United States would benefit from China's accession. The eventual accession agreement codified those checks and balances and extended them to other WTO members. Why were those checks and bal-

ances needed? Simply put, the integration of a non-market economy country the size of China into a trading system—designed for and dependent on the efficient operation of markets—was a challenge of monumental proportions that had never been experienced before and maybe since. On the Chinese side, the task of revising its laws and regulations was astounding. China revised over 2000 laws and regulations and continues still to bring existing laws and regulations into conformity with new obligations as they arise. If observers were to grade China on its efforts to bring its laws and regulations into compliance, just on the basis of the sheer volume of changes, that grade would be significantly above passing.

Benefits to China

China has certainly benefited from the agreement. Its economy has been one of the fastest growing in the world. Its gross domestic product is expected to exceed 11 trillion Yuan or 1.3 trillion U.S. dollars at today's nominal exchange rate. Its GDP is estimated to have grown by 8.5 percent last year, but private economists believe that growth has exceeded 9 percent in the most recent months. Much of the growth has been fueled by increasing investment, which exceeded \$50 billion last year—more direct investment than received by either Japan or, for the first time, the United States.

Benefits to the United States

Statistics do not clearly indicate whether the United States has benefited from the agreement. Since China joined the WTO, U.S. exports to China have grown by over 36 percent, while imports have grown by slightly more than 25 percent. Nevertheless, because the value of imports far exceeds the value of exports, our bilateral surplus continues to grow and may reach \$125 billion this year—almost equal to our global trade deficit last year. The increased exports to China appear to indicate that the U.S. economy is benefiting from China's reduced tariffs, non-tariff measures, and a more open economy. However, a more careful look at the statistics will show that the greatest increases in exports were for crude materials. Instead of benefiting from increased exports of manufactured goods to China, U.S. manufacturers are facing critical shortages of products such as copper, iron, and aluminum scrap—all of which are flowing to China's rapidly expanding economy. The expectation that the United States would see accelerated exports of high technology goods has simply not materialized to the extent that policy makers and legislators hoped and expected. This raises the question of whether the United States has been relegated to the role of a supplier of raw materials to China's burgeoning economy.

Your hearing today is designed to examine China's record in implementing its WTO obligations. Judging from the list of speakers at today's hearing, the Commission should have a comprehensive assessment of China's implementation record and the effectiveness of the U.S. monitoring mechanism. So, rather than repeat what I believe will be detailed presentations of their assessments of China's compliance with its WTO obligations, I would like to take a different track. I would like to step back from the specific commitments in each sector and assess, first, where the shortcomings in exercising the checks and balances have affected China's implementation of the agreement and, second, assess the shortcomings of the agreement itself. I believe that these shortcomings have had and will continue to have a dramatic effect on the overall effectiveness of China's accession agreement and China's integration into the global trading system.

Implementation Deficiencies

USTR has published a detailed list of areas where China has failed to effectively implement its obligations. Not surprisingly, the expectations of negotiators coincide with the actual results. When we negotiated the market access agreement, we expected that China would fully implement those provisions that were specific and detailed and China has, in fact, fully implemented the tariff cuts and actual quota levels (although not the quota allocation system) as we expected. Yet, China's implementation record on the less specific commitments is, as expected, deficient. Like all countries, those deficiencies relate directly to the importance—whether political or economic—of the various sectors that seek protection. Thus the implementation of agricultural tariff rate quotas (TRQs), has failed despite our attempts to create a detailed quota allocation system. Moreover, China has used non-tariff measures to keep other agricultural products out of the marketplace. Soybean exports languished in 2002 due to the uncertainty surrounding restrictions on biotechnology products, until shortages in the domestic market created increased requirements for imported soybeans in 2003. In the auto sector, China mismanaged the quota allocation system effectively denying the negotiated access.

The list of deficiencies includes:

- Questionable use of sanitary and phyto-sanitary restrictions
- Failed administration of TRQs including fertilizers, agricultural, and automotive products
- Capitalization requirements that far exceed the international norms
- Failure to provide trading rights as they affect foreign invested enterprises
- Failure to provide market access for the full range of distribution services

The list is extensive and demonstrates that China is becoming more sophisticated in using regulations to restrict access for foreign supplied goods and services. Given China's success in limiting market access, China should be expected to continue the same practices unless adverse consequences result.

Checks and Balances

As I mentioned in my introductory comments, we purposely negotiated a market access agreement with checks and balances. The checks and balances related to the Transitional Review Mechanism, provisions to take safeguard actions, and the WTO provisions to use the dispute settlement mechanism. While China has been deficient in implementing its obligations, the United States and other WTO members bear some responsibility for those deficiencies. Because WTO members have not exercised their rights under China's accession agreement, the WTO has condoned China's unwillingness to fully implement its WTO obligations. Let me address the following specific provisions: the Transitional Review Mechanism, WTO dispute resolution, and safeguard actions.

Transitional Review Mechanism (TRM)

The TRM has been relegated to a pro-forma session where individual countries complain about China's failure to implement its commitments. The present mechanism is a far cry from what was originally intended and expected by WTO members when China entered the WTO. The original purpose of the TRM was to provide guidance and, when necessary, to apply pressure on China to implement its WTO commitments. The TRM was viewed as a special monitoring and implementation mechanism because negotiators fully realized the extent of China's obligations and the extent to which its still government-controlled economy would have to change in order to conform to expectations of a market economy. In fact, the earlier proposals would have granted greater authority to the TRM in recommending sanctions if and when China neglected to follow its commitments. However, the United States and other countries objected that such a mandate would diminish the rights of WTO members under the dispute settlement process. The prevailing view was that the TRM would be an enhanced consultation and coordination mechanism to resolve disagreements so as not to overload the WTO dispute resolution system.

The process that has evolved bears little relationship to what was envisioned. China has blocked any effective process whereby the relevant committees could report to the WTO council on China's implementation of its accession commitments. Because the WTO process operates under consensus, China has been able to prevent any substantive review by WTO members on the consistency of its laws and regulations to WTO obligations. In effect, China has laid down the gauntlet: the TRM process will not be used as a mechanism to force China into revising its laws to conform to the expectations of WTO members. China views the TRM process as discriminatory against China because no other acceding country was obligated to incorporate such a provision. WTO members, on the other hand, believe the mechanism was a necessary compromise because China was acceding to the WTO prior to implementing its laws and regulations, a concession that no other country has received.

Dispute Resolution

The net effect is that China has challenged WTO members to use dispute resolution as the balancing mechanism. And to date, WTO members have not risen to the challenge. The reasons are legion.

- For small economies, concerns about Chinese retaliation are real especially because their narrow range of traded goods leaves them vulnerable to Chinese pressure and unofficial sanctions.
- For larger economies such as the United States, the EU, and Japan, the diversity of views within each industry makes a WTO challenge difficult. For example, the quota allocation system for automotive vehicles never were implemented as expected with quotas allocated in small quantities to holders who would never use the quotas, and then, never significantly reallocated. However, a WTO dispute settlement challenge was difficult, given that, first, most countries had companies producing in China and thus benefiting from the unfilled quotas and second, most countries recognized that the 18 to 24 month dispute

resolution process would not be worth the effort since quotas would end in 2005. While the automotive industry is only one example, similar commercial considerations argue against governments bringing dispute settlement charges against China in the WTO.

- Other countries simply hide behind the United States. Both the EU and Japan are unwilling to initiate a dispute settlement case against China. Both recognize that they too are subject to retaliation in the form of lost contracts for products like aircraft and telecommunications projects.
- Commercial and now foreign policy concerns also prevent the United States from initiating a case. The most likely one would deal with the VAT rebate system that discriminates against imports of foreign semiconductors and other products such as metal products. Deputy USTR Shiner has indicated that the United States is close to making a decision on such a case. According to press reports, Ambassador Shiner has said that if further bilateral consultations fail to break the current impasse, the United States may have to seek further consultations in the WTO. It is unfortunate that consultations beget consultations but rarely dispute resolution.

The failure of WTO members to use the dispute settlement process means that China has a *carte blanche* in deciding how it implements its WTO obligations.

Safeguard Actions

China's accession agreement includes two product-specific safeguard mechanisms, one for textiles and the other for all products, including textiles. The principle differences between the two are the duration of protection and the mechanism for seeking approval. For textile safeguards, petitions are filed with the Commerce Department and the remedy lasts for one year. For the product-specific safeguards, or section 421, petitions are filed with the International Trade Commission and, if the President grants relief, Chinese imports can be restricted for up to three years with no retaliation, and longer, with the possibility of retaliation.

While the Administration has recently used the textile safeguard mechanism, the United States and other WTO members have failed to use the product-specific safeguard mechanism. The textile provision was actually negotiated prior to the accession agreement in the bilateral textile agreement and was then incorporated into the accession agreement. The purpose of the textile provision was to address market disruption that could occur as China's textile trade was integrated into the phase-out of the textiles agreement. We are seeing that the use of the textile safeguard provision is having a positive impact on China's willingness to explore options that would create a more orderly transition for China. U.S. producers have proposed that China and the United States negotiate a broader range of solutions in exchange for avoiding future textile safeguard actions. In short, the use of the safeguard provision may be effective in achieving solutions that create a more orderly transition to avoid market disruption.

Conversely, the general product-specific safeguard provision—section 421 of our domestic laws—has not been used by the United States or other WTO members. Unlike the other checks and balances in the accession agreement, this provision differs in that its purpose extends beyond the scope of implementation. The purpose of the product-specific safeguard action was to provide temporary relief to industries that suffered market disruption due to competition from China. As a non-market economy country, China, like many Eastern European countries and Russia, does not possess the market mechanisms to bring supply and demand into equilibrium. Thus, its economy tends to create excess capacity and to overproduce, flooding markets in other countries. Even if China fully implementing its WTO obligations, industries in market economies will require temporary protection until those Chinese industries, developed and operated under a non-market environment, learn to adjust and to bring their capacity and production in line with market conditions.

To date, five cases have gone before the International Trade Commission. The first two cases on pedestal actuators and wire rod for coat hangers were denied relief based on a determination by the President that relief was not in the national economic interest. In the third case, the International Trade Commission (ITC) denied relief. In the fourth case on ductile iron waterwork fittings—a case that was brought by my firm, Collier Shannon Scott—the ITC found unanimously in favor of relief, and the interagency process is now reviewing the case in order to make a recommendation to the President. A fifth case on innersprings is currently before the International Trade Commission.

A failure to use the product specific safeguard provision by the United States and other WTO members is a failure to allow the checks and balances of the agreement to work. While I have been assured that this Administration recognizes that the product-specific safeguard mechanism is not limited to cases where China has failed

to implement its commitments, I am not sure that other WTO members are prepared to use the mechanism so broadly. We, the negotiators, intended that provision to go beyond implementation issues. It was intended to address the fundamental inequities when a non-market economy country like China joins a multilateral trading system that depends on the efficient operation of market mechanisms. Simply put, even if China were to fully implement its commitments, the market distortions in China would negate the benefits of China's market opening measures. As a result, Chinese industries would flood WTO markets and ultimately undermine the trading system.

In short, I have been surprised that neither the United States nor the other WTO members have used the product-specific safeguard measures or the dispute settlement process. As long as the United States and other countries fail to use these checks and balances, China will continue to fall short of its WTO obligations and the Trade Review Mechanism will only be used as a debating forum, not as a the mechanism to solve implementation problems as originally intended by the negotiators. We have heard much about accountability in the United States in recent years, for example, in education and in corporate accounting. We must hold China accountable for opening its market as originally intended and expected and as China agreed.

Agreement Deficiencies

Internal Barriers to Competition

While effective use of the checks and balances of the agreement is essential, we must also look beyond the agreement to determine whether other conditions exist that, in effect, nullify and impair the benefits that we and China expected from the agreement. During one of my trips to China, a student asked me what I would do differently if I had the chance to renegotiate the market access agreement. Like so many others, I felt that the 1999 bilateral agreement struck the right balance of what was possible and what was necessary to get China into the WTO and grant it Permanent Normal Trade Relations status. Nevertheless, one element that was completely lacking in the agreement—and that would have greatly enhanced the benefits of the WTO accession package—was a provision to open the internal markets for both Chinese and foreign goods. China needs inter-provincial commerce legislation that would eliminate the barriers to trade among and within the provinces. China's internal market is riddled with barriers. For example, the combination of provincial barriers in the form of tolls, shakedowns, outright prohibitions on using the roads, labor problems in loading and unloading freight, and the lack of an adequate road and rail system make it difficult for companies to establish an efficient nationwide distribution system. According to the American Chamber of Commerce in Shanghai, these barriers can add about 16 percent to the cost of the product compared to roughly 4 percent in developed countries.

The Commission should consider recommendations that urge negotiators to go beyond the confines of China's WTO accession agreement such as inter and intra provincial trade restrictions. This is also an excellent area for cooperation with other trading partners. For example, the EU's internal integration gives it special experience that would serve as a good starting point for negotiations. Trade negotiators need to take a broader look at Chinese internal restrictions that directly and indirectly affect the ability of both Chinese and foreign goods to enter local markets. As long as these barriers continue to restrict internal distribution, China will continue to generate overcapacity and will continue as an export platform, creating market disruption, and eventually trade disputes.

Currency Manipulation

Another area that the Commission should examine is China's manipulation of its exchange rate. To understand its significance, we need only look at the recent history of the Yuan to see that currency alignments have had a significant effect on China, the rest of Asia, and the world. In 1994, China unified its exchange rates and pegged it to the dollar at 8.28 Yuan to the dollar with a very narrow band of about 0.3%. That realignment of exchange rates initiated a realignment of trade and employment. Jobs in other parts of Asia went to China and the relatively small trade deficit with China began its ascent to the stratospheric levels it has reached today. Following the trend in employment, the U.S. trade deficit with the rest of Asia began to decline. Deficits with Southeast Asia and Taiwan declined, and the deficit with Korea actually turned to a surplus. This was the beginning of the Asia Financial crisis of 1997-98.

Other Asian countries, particularly Japan, Korea, and Taiwan, have now aligned their currencies with the Yuan and the dollar in order to protect their trade balances. As a result, all those currencies have become undervalued with respect to the

dollar. Because of the peg, the depreciation of the dollar on international markets has resulted in little or no adjustment in trade with China or other Asian countries. It has also forced all the adjustment in exchange rates onto the Euro, the British Pound, and other floating exchange rates. Like the realignment of exchange rates in 1994, the current situation is unsustainable. And like the Peso crisis and the Asian Financial crisis, the international trading system cannot wait until a global financial bubble bursts.

All experts agree that China's currency is undervalued. Estimates range from The Economists' Big Mac index of 56% to more modest levels. The Fair Currency Coalition believes the currency to be overvalued by as much as 40%. As a result, China is amassing foreign exchange reserves to protect the peg. Reserves have grown to \$400 billion, or about 30 percent of China's Gross Domestic Product and China has indicated that it will use some of these foreign exchange reserves to bail out its banking system. Our trade deficit with China is essentially being used to provide direct relief to the banking system and indirect relief to the highly inefficient state-owned enterprises that China's banking industry underwrites. The irony is that the United States and other WTO members are reluctant to use safeguard measures to provide relief to their own domestic industries that are suffering from market disruption caused, in large part, by Chinese overcapacity.

China's currency manipulation creates an unfair burden on manufacturers. China earns less in dollars on its exports and pays more for its imports priced in dollars, thus impeding U.S. exports. As the dollar depreciates against other currencies, the exchange rate with the Yuan never changes—contributing to a continuing rising deficit with China. Thus, the Fair Currency Alliance, a coalition representing industry, agriculture and labor, has engaged my firm, Collier Shannon Scott, to prepare a section 301 petition against Chinese currency manipulation. The FCA's hope is that the Administration, by accepting the case, will gain leverage with China to bring substantially revalue the Yuan and thus bring its currency into alignment with underlying economic conditions. The examples of the Peso crisis and the Asian Financial crisis have taught us that failure to address unsustainable exchange rate alignments will create global financial crises unless addressed early and significantly.

Conclusion

In summary, any examination of the implementation of China's agreement to join the WTO and the monitoring of those commitments should encompass not only a detailed assessment of the specific commitments but, equally important, it should encompass how the checks and balances of the agreement have been exercised. In the absence of challenges in the form of dispute resolution and safeguard actions on the part of WTO members, China will not be compelled to use the Trade Review Mechanism to resolve disputes or to implement its obligations in the rigorous manner that Congress intended. In addition, the Commission should extend its examination beyond the specifics of the accession agreement itself to encompass measures in China that effectively nullify and impair the benefits that the United States expected. Chinese internal barriers to commerce and China's currency manipulation should be the highest priority of the Commission.

Thank you.

Co-Chair MULLOY. Mr. Cassidy, thank you very much. And I just want to make one comment. You're saying if you had to do it over again, the currency, obviously, is an issue that should be discussed further. And when you think about it, the wisdom of the people who put that together, the international trading system after World War II, was that they did address currency issues as part of the IMF's role.

And, of course, that whole thing broke down 30 years ago. Now, trade flows are not moving currencies. It's the capital flows that are moving currency, and I agree with you: I think this is an urgent issue to get back into discussion of the trading system. But I won't go on with that now, but I just want to throw that out there, because I think it was part and parcel of the trading system as envisioned by the architects after World War II.

Panel II—Discussion, Questions and Answers

Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

Thank you for your testimony both of you. I think it's very important testimony. It does shed serious light on the problems that we are facing in terms of their WTO commitments. I think this is very important; the TRM, the transitional review mechanism, is in danger of becoming almost a nullity in terms of monitoring, and evaluating performance with concomitant recommendations every year. That's not part of the system under the TRM now. I think it was contemplated to be so.

In some ways, I think Mr. Cassidy, you're right, that members that we talk to in Geneva are far enough away from the idea of them, themselves, bringing a case that we've got more of a fear-based system than a rules-based system. And until a couple of important cases are brought, I'm not sure the Chinese are going to take this system really that seriously and start moving in the right direction.

And on the question of cases, I'd like to ask you two both: did I hear you right, Mr. Stewart, that you believe that the currency issue is a matter that would be something that would be legitimately subject to bringing a case under the WTO?

Mr. STEWART. Well, as Bob mentioned, his firm has been retained by the Fair Currency Alliance to pursue exactly that type of matter. But if you look at the WTO and the predecessor, the GATT, there are a variety of GATT articles that make currency manipulation potentially actionable, including within domestic law.

Article VI, which deals with both dumping and countervailing duties in the GATT, since its beginning has had notes which indicate that certain forms of currency manipulation can constitute prohibited export subsidies or can constitute a form of dumping, both of which could be actionable under Article VI.

Under our domestic law, it would be hard to argue that our dumping statute would permit us to go after that, so there is a possibility for a statutory change on that type of an element. On the subsidy side, there has not been a case raised, but there could be some interesting arguments made under domestic law that one could reach it.

The big issue with China is that, for a number of Administrations now, the view has been that they can't use the countervailing duty laws to go after subsidies in nonmarket economies, even though we negotiated very hard to put limits on subsidies in China. And so, there are legislative proposals to change that as well.

So, whether it's the 301 action to go after currency misalignment, the use of existing domestic laws or modification of domestic laws to let you take advantage of WTO rights, there are things that can and should be done to put a lot of pressure on China to repeg its currency.

Vice Chairman D'AMATO. Mr. Cassidy?

Mr. CASSIDY. Let me just say first that with relationship to having negotiated the agreement, what I would do over again, I didn't mean to put currency alignment in that category; it was actually the internal barriers for trade.

The basis for a 301 case is, as Mr. Stewart pointed out, there are a lot of areas that one could look at. There's Article 15; there are the IMF Articles of Agreement; there are export subsidy argu-

ments. We're looking at all of these to what extent these would be inconsistent with China's general WTO obligations, and we hope that we can provide a comprehensive list of those.

Vice Chairman D'AMATO. I'll just follow that up with a quick question. Does that include, in your assessment, the behavior of the state-owned banks? Because obviously, they're a central player in the whole question of whether this is a market-based system; you know, the subsidization of the state-owned industries by the banks, low interest rates, forgiving loans, all of that constant behavior rigs the whole system in the way of subsidies. Is that your understanding?

Mr. CASSIDY. Well, I think there may be two separate issues here. Certainly the state-owned banks are involved in maintaining the peg. There is the separate issue of state-owned subsidies going through the state-owned banks to individual industries, and I think that's been an issue that some industries have indicated is problematic.

The bailout of the banking system, some have argued, and I think many are looking into, how that has become an effective subsidy to the state-owned enterprises and represents a transfer of funds to those state-owned enterprises and distorts the trade.

Co-Chair MULLOY. Thank you.

Oh, I'm sorry, Mr. Stewart?

Mr. STEWART. China undertook a separate obligation to terminate coverage of operating losses of state-owned enterprises, and there has been no information supplied to date on that. And the \$85 billion bailout that has occurred in the last month of three of the major banks raises serious concerns of whether that is ongoing, so it is a classic issue in this particular context.

Vice Chairman D'AMATO. Thank you.

Co-Chair MULLOY. I'm going to ask each Commissioner if you can get in and out in four minutes, in order to give everybody who wants an opportunity to ask questions and then meet our luncheon obligation, so four minutes.

Commissioner Dreyer?

Commissioner TEUFEL DREYER. I can do it faster.

I seem to read into your collective testimonies that you feel that the problems that have arisen are less in terms of how the WTO agreement, the accession agreement, was written but more to a mix of Chinese intransigence and a failure of American political will to really try reinforce that. Is that fair?

Mr. CASSIDY. Yes, I would—I mean, there would be those who will criticize us on the way we negotiated the agreement and did we foresee a lot of different things that should have been included in there; for example, how specific should we have been on some of the transparency issues? Maybe we should have been more detailed on them.

We tried to be incredibly detailed on the agreement, in part because we felt that in the light of past experience, failure to be detailed meant that it created more loopholes. But so much in the agreement are in essence general obligations to then conform to the Chinese system.

All countries that entered the WTO into the past had to bring their laws into conformity with the WTO obligations before they

entered, so all the WTO members could actually look at what the laws were and how they were being implemented. The major concession to China was to let it enter into the WTO before the laws were changed, and thus that was the basis for having something like the trade review mechanism, for having the 421 provision, all of these.

So that was one of the—I mean, yes we could perhaps have done a better job, but in essence, it's Chinese implementation of those laws that are the problem. And then, I would argue, as I did, that WTO members have not stepped up to the plate to use the checks and balances that we as negotiators intended.

Commissioner TEUFEL DREYER. Mr. Stewart?

Mr. STEWART. I agree with much of what Bob has said. However, I think that by the time we got to letting China into the WTO, many of our major sectors where we have had historically significant competitive advantage, whether it's information technology, the telecom sectors, et cetera, had already been co-opted in China. If you look at the extraordinary expenditures that have occurred in China in those sectors, for example, in the last 10 years, the U.S. share of those markets was under, I believe in both cases, under a half of 1 percent of the market.

And that was because of a series of barriers that China had: requirements to invest if you were going to participate, et cetera, et cetera. And so, if you look at where we're having problems, they tend to be in areas where we have comparative advantage vis-à-vis China, whether it's in our automotive sector, semiconductor sector, et cetera, et cetera. They are being very good at protecting their own turf, and we have started at a major disadvantage.

I believe that the Administration has put great effort into trying to deal with particular problems as they arise. And the history of GATT/WTO accessions, has been countries get a period of time to deal with bringing themselves into compliance before they get hit with cases. So the fact that there haven't been cases in the first two years is not atypical; I would say it's normal, because China is making efforts in many directions.

Commissioner TEUFEL DREYER. So, to ask you the question that George Becker asked earlier, do you feel that WTO compliance laws are being taken very lightly because of political reasons?

Mr. STEWART. The Section 421 cases clearly have been influenced by the heavy lobbying that the Chinese government has done. 421 cases are brought by small industries that are in extreme crisis. They have very limited resources, and to think that they're going to be able to compete against the Chinese government for the attention of the U.S. Government is nonsense.

421 was supposed to be fairly automatic. There are also a lot of problems being created in 421 by the International Trade Commission that is putting barriers up because of the short time frame, which basically knocks out a huge percentage of industries that could use the law.

Co-Chair MULLOY. Thank you.

Commissioner Wessel?

Commissioner WESSEL. Thank you both. Your expertise is valued by this Commission, the work you've done in the past, Mr. Stewart and Mr. Cassidy, your ongoing work, we appreciate tremendously.

I guess we are one of the checks and balances; this Commission was created as one of the checks and balances in the system. In the aftermath of PNTR, the Congress created this Commission as an ongoing review mechanism. And as part of that, it's our job or goal to recommend changes that Congress may want to look at over time.

We will have a report due to Congress in the next couple of months. If there were one or two changes each of you could recommend we suggest, what would those be?

Mr. STEWART. Several areas: I, like Bob, believe that competing against a nation that has undervalued their currency by as much as China is a cross-sectoral problem that needs to be addressed. And I think that there are things, whether it's permitting U.S. companies to go after NME economies under the countervail law or whether it's fleshing out the rights that we have under Article VI to either do dumping or subsidy cases against undervalued currencies that would be major tools that would get the attention not only of China but probably some of our other Asian trading partners who have felt the need to do similar types of things.

Other than that, the overriding issue is that we don't have meaningful investment commitments. Investment has always been a small part of the WTO, and if you look at where we are systematically excluded, absent commitments to transfer technology and basically shift the focus of manufacturing from the U.S. to China, it is exactly in the investment area.

I think that is critical. I think the intellectual property issues are questions of enforcement, where I think that disputes have to be brought, and I think that those three things explain a good part of the deficit that we see.

Commissioner WESSEL. Mr. Cassidy?

Mr. CASSIDY. Certainly, I agree with Terry on the currency issue. That's the primary issue, in my view at the present time, because it does deal not only with goods but also with services. I would also argue that, from a tactical perspective, that a WTO case and certainly helping out the smaller companies and 421 are important.

But, you know, one of the areas that I didn't concentrate on, because I was looking at it from the checks and balances side, but the one area in the negotiations that we focused on was trading rights and distribution, because essentially, if you don't have that, you can't get your product to China, and you can't get your product throughout China.

And then, all it becomes is an export platform. So, one of the areas that I think that needs to be focused on because all aspects of the agreement hinge on that one area—not all aspects but a hefty amount of the benefits depend on that. So that would be one of the areas that I would say that the most attention needs to be focused on.

Mr. STEWART. Just to follow up on Bob's point, if you look at the distribution and the trading rights, those obligations all mature for everything by the end of this year. And so, what the Chinese have done by delay is to basically buy themselves three years of non-compliance for any foreign-invested companies in China on trading rights and distribution rights. And that's part of the problem: three

years is a long time when other companies are expanding internally.

Commissioner WESSEL. Let me just in closing, number one, thank you, but also, the Wall Street Journal, just a couple of weeks ago, had an article that—somewhat ironic, I should say—that Wal-Mart, one of the great icons of the China threat here in our market in many ways, is having its distribution rights in China restricted and may be unable to open new stores at this point.

Maybe we both see Wal-Mart as a threat to our trading posture, but I agree with you that the distribution rights are something we need to move to the center of the radar screen.

Co-Chair MULLOY. Thank you both on that particular point on the recommendations. And we may be coming back for you to help us scope those out in terms of our own work and making recommendations to the Congress.

Commissioner Reinsch?

Co-Chair REINSCH. Thank you; very thoughtful testimony, Bob. I thank you for it. You've belied what I told some of my colleagues this morning when I said I didn't think we were going to hear anything we hadn't heard before. You have managed to produce something we haven't heard before, and I thank you for that.

A short question, first: the currency issue, does the coalition favor a float or a repeg?

Mr. CASSIDY. Bill, I'd prefer that the Alliance—

Co-Chair REINSCH. Sorry, the Alliance.

Mr. CASSIDY.—answers that question.

I think that what they have said is that they need a significant realignment of the currency.

The problem that I have personally with the float is that I don't think the Chinese system can accommodate a float at this time, and that is a longer-term objective. And so, does that mean that if that is the only objective that we have, that U.S. manufacturers are then subject to the disequilibria that is resulting from it? So my answer is no, to myself anyway.

And so, my argument is that we need a significant realignment of the currencies. How we achieve it is—I leave it up to the Treasury Department and others who are much more knowledgeable about it. But I think we need a realignment of the exchange rate.

Co-Chair REINSCH. For what it's worth, I think you're right, except that that then raises the question of where you're going to set it and how you determine what the right amount is. And as you've mentioned in your own testimony, there are estimates all over the map; in fact, over a much broader range of revaluation than what you've cited.

I want to pick up on something that Commissioner Dreyer said. What I took from your testimony was, in a sense, a different criticism of the negotiations, which was that you've come back and blamed the businesses, not without reason, or the government for not asserting its rights as it has the opportunity to do in various dispute resolution fora. I think that's a well-taken point.

At the same time, it seems to me that hindsight on these things is 20–20. We should have figured out that the greater our economic stake there, which is growing rapidly, the more likely this set of events would occur. Why didn't we anticipate this problem?

Mr. CASSIDY. I'm not so sure we didn't—we always knew that implementation of this agreement was going to be difficult, because we would have—and it's not true just of China; it's true of every other trade issue—we're going to have people on both sides of the issue.

And it's going to happen within an industry, and it's going to happen in a broader sense. You have a whole set of multinational companies that are invested in China, that have a global strategy in sourcing and supply management, and we also have a group of companies that are smaller in nature.

So we do have this diversity. It doesn't mean that we cannot use the mechanisms that are there, but we have to tailor them specifically to what the objectives were in the agreement and what is the most important. It doesn't mean that we have to do a shotgun approach on using a 421 or WTO cases, but they can be tailored, and they can be tailored to the needs. And once again, I say that distribution and the trading rights issue is so critical to the agreement. Currency alignment is also important.

And so, I think that they can be tailored in a way that is tactically and strategically designed and yet does not necessarily impinge on everybody's interests in China.

Co-Chair REINSCH. That's very helpful.

Mr. Stewart, there is no time here, but perhaps you can supply us your advice on the CVD issue, on exactly how you would go calculating the amount of subsidy in a nonmarket economy where costs and prices are fixed by the state.

Mr. STEWART. Pleased to. I remind you that in the protocol of accession itself, they provide special rules that let you make comparisons to market economies if you need to.

Co-Chair MULLOY. Thank you, Commissioner Reinsch.

Commissioner Becker, and we're going to get in and out quickly and then move on.

Commissioner BECKER. Yes, thank you. Just a very quick question. But first, Terry, going through your prepared testimony you cite one failure after another in almost every category. I was reading recently where some 85 percent of the trade cases that have been filed—either antidumping, countervailing duty or safeguards—have been ruled illegal or improper by the WTO.

My question to you is whether this is a vehicle that we can depend on any more to protect industry and protect the industry from surges and illegal dumping in this country?

Mr. STEWART. Commissioner Becker, in terms of the special surge mechanism, that has been effectively taken out of play, although there are still cases that are being pursued by the aggressiveness that China has pursued politically to try to see that the remedy is seldom if ever made available.

With regard to the trade remedies themselves, we do have problems in the dispute settlement area, because the remedies are not favored by certain countries, and the dispute settlement process is largely a plaintiffs' forum.

Historically, under the GATT, cases were seldom brought. And so, when they were brought, it was usually viewed that there was a major problem. That mentality has kind of been carried over, and it's not simply in the rules area, but you still have a 90–95 percent

win rate if you're the complaining party, which leads to a lot of cases being brought.

So there are some very real problems, and the Administration has some serious challenges if they are to make good on their commitment that the package that comes out of Doha, if there ever is a Doha round completed, will result in strengthening and not weakening of the laws.

Commissioner BECKER. Let me tighten that up just a little bit. This is not a matter of political will then, as I understand it; it is a matter that the law is inadequate, and if this is the case, I'm wondering what you would suggest that we do in this.

Mr. STEWART. Well 421, I think the law is adequate. It has proven to be unusable, because, as is true in any case where there is not an unfair trade practice alleged, the President always has discretion. And in the 421 case, you have a government, China, which is determined to see that the special provisions in the WTO accession protocol aren't used. And they have put efforts in, which are unrealistic in terms of the actual trade effect for China, to make sure that these things don't get off the ground and aren't used.

So you either have to take away the discretion of the President, which I don't see happening on this or any of these types of laws, or it is a question of political will. The Administration simply has to recognize that there was a different purpose intended and use the laws accordingly.

Commissioner BECKER. I see our time is up. Thank you very much.

Co-Chair MULLOY. Thank you.

Before I turn to Chairman Robinson, I just want to follow up on that last issue. You said that there was a lot of lobbying. I asked the first panel: are there any political considerations? And they said no, this is all being done on economic grounds.

Now, you pointed out the split between our multinational community, which is very interested in expanding operations in China, and our domestic industry, which is very interested in holding onto jobs and work in this country. Who's lobbying? Is it the multinationals that are interested? Or is it the Chinese government? And who do they use to do the lobbying? Do they use law firms, or how is it done? It's important to tell our audience that.

Mr. STEWART. Well, we brought the first 421 case, and it was for a small company in New Jersey that had lost about a third of its market in six or eight months and was worried about its ability to stay in business.

And as I recall, the Chinese government hired two law firms and one or two government relations firms to make sure that the case didn't come out with a recommendation from the President for relief.

Obviously, they're allowed to do that under our system, but the concept that you have a small company in New Jersey that is struggling to hold on to jobs in America, has a remedy that the way Congress had written it up was supposed to be fairly automatic and only denied in extraordinary circumstances, what's being applied, the standard that's being applied is the standard that used to be applied under 201 and was not the intended approach to be used under 421.

So there's massive lobbying that's been going on, and they'll use the most prestigious firms they can find who don't have a conflict. Co-Chair MULLOY. Thank you very much. That's very enlightening.

Chairman Robinson, I yield to you.

Chairman ROBINSON. I thank both of you very much. That was enlightening testimony, and we greatly appreciate it.

We will be sending out transcripts of these proceedings early next week, and we would just ask our panelists if they wouldn't mind turning that around as quickly as possible. We'll seek to have these proceedings published in the next few weeks.

With that I would only also apologize to Chairman Ney, whose name I mispronounced earlier today, and thank him again for the use of this august setting.

Thank you again. We will reconvene at 2:10.

[Whereupon, at 12:56 p.m., the meeting recessed for lunch, to reconvene at 2:12 p.m.]

AFTERNOON SESSION, 2:12 P.M., THURSDAY, FEBRUARY 5, 2004

PANEL III: AGRICULTURE, LABOR AND BUSINESS VIEWS

OPENING REMARKS OF CO-CHAIR WILLIAM A. REINSCH

Co-Chair REINSCH. Well, welcome back everyone. I want to open the second half of the hearing for the two afternoon panels.

On the first panel, I want to welcome Robert Kapp, President of the U.S.-China Business Council, Richard Trumka, Secretary-Treasurer of the AFL-CIO, Robert Vastine, President of the Coalition of Service Industries, and Robert Carlson, President of the North Dakota Farmers Union and here today also representing the National Farmers Union.

Following this panel, we will have a second, and those panelists will be Bill Primosch, Director of International Business Policy for the NAM, Eric Smith, President of the International Intellectual Property Alliance, Anne Craib, Director for International Trade and Government Affairs for the Semiconductor Association, and Ann Wroblewski, International Vice-President of the American Forest and Paper Association.

Let me also mention that two additional statements have been submitted for the record, one from Timothy Trainer, President of the International Anti-Counterfeiting Coalition and one from Brad Smith, Managing Director for International Relations, the American Council of Life Insurers.

I understand from one of my panelists, Mr. Vastine, that he has a conflict that he's going to have to leave a little bit early for, so I think what we will do is take testimony going from my left to your right, Mr. Kapp, Mr. Trumka, Mr. Vastine, Mr. Carlson in that order, but then when you've concluded, I'll ask the Commissioners if they have any questions for Vastine in particular. If you don't mind, we'll do those first. And then, we can excuse him, and then, we'll have a round for the other panelists, and that will accommodate his schedule.

Let me also particularly express my personal appreciation to Mr. Kapp for being able to come today. I know it's difficult, given his schedule, and I really am grateful. I think it's very important that

we hear directly from businesses, farmers and workers who are the ones that are most engaged in trying to deal with China both there and here and are really in the best position to comment on the question of WTO compliance.

Because we are late, I want to be fairly ruthless on the gavel. The witnesses are going to stick to seven minutes or below. The Commissioners are going to stick to five minutes or be gavelled into silence, and just to alert Commissioners, once we get started, I'm going to start with Mr. Becker and work my way around for the first panel. And then, for the second panel, I'm going to start with Commissioner Wortzel and work my way around the other way.

And with that, Mr. Kapp, welcome.

Co-Chair MULLOY. Commissioner Reinsch, let me just say this: I wanted to let Mr. Carlson know—Mr. Carlson, Senator Dorgan appeared here as our first witness this morning, and he was sorry that he could not be here to introduce you. But he did give us some very good testimony regarding the concern of wheat farmers in North Dakota.

So, thank you again.

Mr. CARLSON. Thank you.

Co-Chair REINSCH. Mr. Kapp?

[The statement follows:]

Opening Statement by Hearing Co-Chair William A. Reinsch

This morning we heard from Executive Branch officials who provided us with an overview of China's WTO compliance record to date as well as U.S. Government efforts to monitor and enforce China's compliance. We also had the opportunity to hear from legal experts intimately familiar with China's WTO commitments, who were able to discuss the steps that China has taken to adhere to their commitments as well as the improvements that remain to be made.

We now welcome to our first afternoon panel four distinguished leaders of national organizations that represent different sectors of the American economy. They are: Robert Kapp, President of the U.S.-China Business Council; Richard Trumka, Secretary-Treasurer of the AFL-CIO; Robert Vastine, President of the Coalition of Service Industries; and Robert Carlson, President of the North Dakota Farmer's Union and here today also representing the National Farmer's Union. Thank you all for your contribution to the work of our Commission.

Following this group of witnesses, our final panel will convene at about 3:20. The four panelists will be William Primosch, Director of International Business Policy for the National Association of Manufacturers; Eric Smith, President of the International Intellectual Property Alliance; Anne Craib, Director for International Trade and Government Affairs for the Semiconductor Industry Association; and Ann Wroblewski, International Vice-President of the American Forest and Paper Association.

These panelists will collectively provide a comprehensive view of the opportunities and concerns presented to American businesses, workers and farmers as a result of China's accession to the WTO. Each represents individuals and companies who have dealt first-hand with these opportunities and concerns. It is, in the end, individual companies who know best the specifics of China's adherence to WTO norms as well as the inconsistencies in China's implementation of compliance-oriented reforms. It is individual companies, workers and farmers who know best the lost opportunities and adverse affects of China's non-compliance, as well as the opportunities that can emerge from a burgeoning economic relationship aided by the lowering of Chinese import barriers.

We hope to gain from these panels an understanding of the specific concerns faced by workers, companies, and industries with respect to China's WTO compliance. We also hope to distill from our discussion today some concrete proposals to ensure that the U.S. Government is responsive to such concerns, as it must be if we are to realize the full potential of China's membership in the WTO.

**STATEMENT OF ROBERT KAPP
PRESIDENT, U.S.-CHINA BUSINESS COUNCIL**

Mr. KAPP. Thank you. I appreciate your inviting me down today, and I must say it was the persuasive power of Commissioner Reinsch that provided the magic here. But my schedule is certainly no busier than that of the other witnesses, and I don't mean to imply that my being here is any more of a sacrifice than Rich Trumka's or Bob Vastine's or Bob Carlson's time would make it.

I have offered a number of written pieces, and I am enough of an old academic to hope that they get read. Most of them were written earlier. We testified before the TPSC, the Trade Policy Staff Committee, as recently as last October, and prepared a major one a year—in this case for the second year assessment of China's WTO progress—for that hearing. You've got that. You've got my oral comments that went with that. You have the newest thing we've written, which is an article from the latest issue of our magazine, *The China Business Review*, talking about Year Three, much of that article is descriptive of what Year Three is supposed to hold according to the phase-ins in the original WTO accession agreements.

And then, you have a very short document called "Testimony of Robert A. Kapp, President, U.S.-China Business Council, February 5, 2004," which is my written oral testimony for this Commission hearing.

I am not going to read all of that. There is one important correction for the record, however. On page 3 of this testimony written today, under Arabic 3, letter F, Auto Finance Regulations, I have written "...These rules...have not been issued," when, in fact, it should read "...T/hese rules have been issued." So I ask that the record show that the word "not" was mistaken and that the record delete that word.

You know, business with China is very good right now. The economy over there is growing like mad. I said during the PNTR battle that the thing that would really make a difference to American exports to China, even more than anything in the WTO agreements, was whether the Chinese economy was growing at 10 percent a year or shrinking at 10 percent a year. And happily, for the moment, at least, the Chinese economy has been growing for some time now at nearly 10 percent a year. Exports are way up in many categories, as we know. With regard to U.S. foreign investment into China last year was, interestingly enough, utilized foreign investment was not up very much, and the percentage or the share of total foreign investment in China accounted for by U.S. investors remains, either on a contracted or utilized basis, well under 10 percent.

Utilized FDI in China as a whole last year utilized was only up by 1.4 percent partly because of SARS, perhaps. But in terms of the business environment in which we look at China and the WTO at this time, things look quite strong. We consider the USTR's year-end report even more thorough, much more thorough in some ways than our own October report, and we commend the USTR for giving it the attention it needed. We defer to most or its itemizations as to where the problems are.

Much of the testimony submitted by other witnesses today repeats the familiar problems, and I think by now, you know what they are: there are problems with standards, there are problems with insurance, there are problems with air express, there are problems which are not necessarily WTO actionable looming in the area of government procurement. There are some problems still of opacity and, incompleteness of regulations—regulations and laws which, though issued, either are difficult to interpret or seem to raise new barriers to international participation in the Chinese economy. I have itemized those in my written oral testimony.

I make only a few comments about the RMB matter. We can touch on it if you want. I suspect that most of the Commissioners and I would not agree on that, but I'm happy to discuss it. I do think we may be seeing the emergence of a new, longer-term pattern in China's trade behavior, and I think the USTR's December 2003 report on PRC compliance in the WTO is suggestive of this. If you look at the last month or two of 2003, when a lot happened after we did our report, and in some cases even after the USTR finished their document, you could see that perhaps by the beginning of the third year, we're able to perceive the outlines of a new pattern here.

It's not a perfect pattern. It's a pattern in which some things get done right on the button; some things are late but they do get done late, and consultation between the U.S. and Chinese governments on many issues remains at high and even heightened levels. Without it, the prospects of reaching satisfactory understandings on some of these issues might be much less promising.

In my October testimony, I worried out loud that we might, in view of the faltering or the halting progress China had made during the Year Two, be looking at what I call "a yard by yard ground game," in which every single inch of the field was fought over and fought over back and forth in an endless battle of attrition.

That's the dark side of recognizing that not everything is being accomplished in full and on time on the day it was supposed to be and many issues have required additional discussion between the U.S. and Chinese governments in particular. A more positive way to look at that, however, may be coming into view, and that is that with continued attention, high level interventions, with constant engagement between USTR and Commerce, on the U.S. side and the Ministry of Commerce and other agencies on the Chinese side, even at the State Council level, some of these issues which have either been delayed or which have been announced by the Chinese in forms that are not satisfactorily clear, not satisfactorily compliant, in our view, with China's obligations, can still be brought to satisfactory conclusions.

There has, in fact, been progress on some of the nastiest issues of six months ago. Auto finance is an obvious one. I'll defer to Mr. Carlson in large measure on agriculture, but clearly, the ag TRQ situation is not the same today as it was six months ago, and so forth.

So, it's a little early to know. A year from now—if we get together at the end of Year Three looking at Year Four, that pattern may have become clearer. It's much too soon to declare that we're going in a completely positive direction, and the directly affected

sectors—air express a classic case; or semiconductor manufacturers on the question of the differential use of the VAT tax for domestic and foreign-produced semiconductors; the insurance issue, with all of its complexities—companies are very unhappy and with good reason. Nothing I have said here is intended to diminish these concerns. Those people are my constituents. But the fact remains that in this mixed picture, against the background of a strong Chinese economy and a great deal of American business success in China right now, (including the export of things like steel, which is a reflection of the rapid growth of the Chinese infrastructure and building sectors and something of a surprise), I think it's possible to say that the glass remains half full.

You're going to say "What letter grade will you give China?" And I'm going to tell you that I've been a professor, and I don't give letter grades in Commission hearings.

[The statement follows:]

**Prepared Testimony of Robert A. Kapp
President, U.S.-China Business Council**

Thank you for inviting me to meet with you today.

Since I testified at the first hearing of this Commission, much has happened in the world, in the United States, in China, and in United States-China relations. Suffice it to say that after years of tumult, events following the release of the United States Navy EP-3 aircraft from Hainan Island and the terrible attack of September 11 have contributed to a warming of U.S.-China relations across many sectors. It has been an extremely eventful three years, and the atmosphere that prevailed when the Commission was created has changed significantly under the pressure of world events and changes in U.S. and PRC conduct. While by no means the most significant development in this period, the accession of the PRC to membership in the World Trade Organization, just as the U.S. and world economies fell into serious difficulties that the aftermath of September 11 only made worse, has been a major milestone in the history of China's economic modernization and its commercial and economic relations with the world's major trading nations, including the United States.

This Commission was created late in 2000, shortly after the Senate's passage of legislation establishing Permanent Normal Trade Relations for China. The actions of the House and Senate, in May and October, 2000, establishing PNTR treatment for China, contributed significantly to the completion of WTO negotiations with China over the specific terms of PRC membership in the WTO, and China became a WTO member on the 11th of December, 2001.

Given the massive political debate that surrounded the Congressional decision on PNTR, it was understandable and appropriate that both the executive and legislative branches made formal commitments to minute monitoring of China's performance of its WTO obligations following accession. WTO compliance became something of an overnight sensation, and a range of U.S. agencies has been focusing on the topic ever since. It is an understatement to note that there has been no lack of compliance investigations since accession.

The U.S.-China Business Council has maintained a constructive dialogue with several U.S. Government agencies, notably the Office of the U.S. Trade Representative and the Department of Commerce, in regard to post-accession, as it did in the years leading to accession.

The Council has offered two annual evaluations of China's WTO progress to date, and has submitted those, with accompanying brief oral testimony, to the annual hearings of the Trade Policy Staff Committee (TPSC). Elements of the Council's analysis, with that of many other trade groups, has perhaps helped the USTR in formulating its annual China WTO report to the Congress.

Since the Council has so recently conducted a detailed examination of Chinese WTO progress, and so recently published its conclusions, I am submitting the Council's September, 2003 Year Two analysis as part of my written testimony today, together with the oral testimony I offered to the Trade Policy Staff Committee at its October 2003 meeting. In addition, I am pleased to provide an article from the latest issue of our magazine, *The China Business Review*, which looks ahead to the coming of China's third-year tasks.

For today's purposes, a few additional points should suffice.

1. The USTR report to Congress, dated December 2003, is more recent than our Council's materials dating from autumn, 2003. We applaud the USTR for its thoroughness, and suggest that the USTR's description of the status of outstanding issues is generally authoritative through the time of its publication.
2. We may be seeing, as we work into the third year of China's WTO participation, an emerging pattern:
 - a. The implementation, on time and in full, of some major commitments, notably but not exclusively in tariffs;
 - b. the delayed promulgation of certain key measures whose failure to emerge exactly on schedule caused anxiety and dissatisfaction in the U.S. and elsewhere;
 - c. the extensive and intensive consultation between duly constituted U.S. and Chinese authorities on numerous issues, resulting at times in the resolution or the defusing—or the temporary postponement—of trade conflicts;
 - d. the slow, halting, but steady approach of certain major changes in government administrative practice, including increased transparency and the elimination of complex "application and permission" systems in favor of simpler registration systems less liable to official obstruction or corruption;
 - e. the emergence of legal or regulatory measures that pose very serious new obstacles to international participation in certain sectors of the Chinese economy, raising questions of national treatment under WTO;
 - f. signs of an increasing Chinese interest in defining technical standards for international firms to meet, rather than simply in establishing externally-written technical standards as authoritative within China; this may or may not have specific WTO implications;
 - g. continued hesitation in some areas to promulgate regulations that American firms consider fully compatible with China's WTO accession agreements;
 - h. slow progress on the perennial issue of intellectual property protection;
 - i. persistence of a pattern of economic dirigisme in certain sectors, the implications of which for China's WTO obligations will require close observation.
3. The very end of 2003 saw movement by China on some of the outstanding issues of its WTO membership, and further movement is expected in early 2004. This is discussed in the recent China Business Review article. Here are examples:
 - a. Trading rights. A draft of the new Foreign Trade Law has begun to circulate. It is expected to simplify the granting of trading rights by mandating a simple examination and approval process, and thus to approach the meeting of WTO requirements;
 - b. Distribution. Some forms of liberalization took place in 2003 (See the China Business Review article), while new regulations on the Management of Foreign Invested Commercial Enterprises, expected soon, are expected to liberalize further this sector;
 - c. GMO. This issue has approached resolution with a verbal agreement in December of 2003 between the USDA and the PRC agriculture ministry certifying GMO products;
 - d. TRQ. The PRC belatedly issued regulations in the fall of 2003 outlining the TRQ allocation process. Some concerns regarding TRQ administration, however remain;
 - e. High capital requirements in the service sector. We understand that quiet work is underway to persuade China to eliminate or reduce some of these onerous requirements;
 - f. Auto finance regulations. These rules, on which we placed considerable emphasis in our Fall 2003 report, have been issued, and the first automobile companies to seek to set up auto financing systems, including General Motors, have been approved;
 - g. VAT issues. These have not been resolved, but the two sides are apparently in substantive content in regard to them. The problem is particularly acute in the area of semiconductors and fertilizer;
 - h. Tariffs. A new tariff law took effect January 1, bringing China closer to international standards for valuing imported and exported goods and for implementing tariff levies established according to the provisions of the law;
 - i. Insurance. Five new cities were opened to foreign nonlife insurance companies December 12, 2003. By the end of 2004 geographic restrictions on foreign insurers are scheduled to be eliminated. Serious disagreements, however, remain in the area of Chinese regulations regarding the corporate structures required for branching.

A number of issues of very serious concern to individual sectors of the U.S. economy, and to individual companies, remain to be dealt with or have arisen since accession. The United States and China have established a reasonably robust engagement on WTO-related issues, even as the overall engagement of the two governments has expanded and improved. Signs of “pushback”—resistance or delay in regard to WTO-mandated reforms of established practices—from sectors of the Chinese economy which may, in some cases, not have understood at the time the full contents and implications for them of China’s 2001 WTO commitments, have surfaced.

Meanwhile, 2003 saw the beginning of what many predict will be a tide of “Safeguard” cases against Chinese imports to the United States as well as a continuing flow of U.S. anti-dumping cases, which now see parallel anti-dumping procedures in China with increasingly frequency. In 2003, the question arose as to whether the PRC peg of the currency to the U.S. dollar constitutes a form of “manipulation of the currency” requiring a stern and trade-restricting U.S. response. The claim is debatable (key sources would be the Congressional Research Service December 2003 report on the RMB peg, the testimony of Congressional Budget Office’s director to the House Ways and Means Committee on October 20, 2003; and the speech by Fed Chairman Alan Greenspan to the Dallas World Affairs Council in December of 2003.)

The direct link of this issue to WTO is tenuous. At this time, an entity has arisen in Washington to support the bringing of an unfair trade case against China, under American law, over the maintenance of the RMB peg to the dollar at the current rate.

As pointed out above, serious concerns exist in some segments of the U.S. business community as to China’s policies and practices subsequent to PRC accession to the WTO. Nevertheless, we believe that the intensive engagement that the United States and China have created on trade and economic issues in the months following the installation of the new Chinese government and the SARS emergency in the spring and summer of 2003 represents the most promising approach to the identification and resolution of WTO-related issues in the Chinese trade regime.

Trade and economic relations with China have once again emerged as a frequently raised discussion topic (if not, to date, a potent vote-getter) on the campaign trail in the current U.S. political season; this was demonstrated by the Commission’s foray into South Carolina and the testimony of its witnesses there, only a few days before the intensely publicized South Carolina presidential primary.

If it is indeed true, as reported by the Associated Press, that a Member of the United States Senate declared, following testimony to your group, that “This is not a cold war, this is a hot war. . . This is a nuclear war when it comes to our economy. And they’re using nuclear weapons. . . . They have made a conscious effort as a government to steal market share. . . .”, only time will tell whether such sentiments and rhetoric will make objective examination of the complexities of China’s WTO progress into a footnote.

I am happy to take questions, and hope to learn more about the Commission’s perceptions after two and one half years of its operations.

Appendix 1 to Robert Kapp’s Testimony

CHINA’S WTO MEMBERSHIP IN THE SECOND YEAR OCTOBER 3, 2003

Members of the TPSC, ladies and gentlemen:

Thank you for convening this meeting to discuss China’s progress in implementation of its WTO accession commitments during the second year of its membership in the organization.

I will keep my remarks very brief, referring members of the Committee to a longer written document, prepared by the exceptionally capable staff of the U.S.-China Business Council led by Director of Business Advisory Services Karen M. Sutter. The written submission draws on results of a poll of the Council’s members. While the total number of respondents to our questionnaire was not enormous, we feel that a very substantial portion of the corporate membership most directly affected by specific WTO accession issues did respond, and that the conclusions we have drawn from their comments merit serious consideration.

Last year, as we approached the end of the first year of China’s WTO membership, I noted that the “glass was half full,” rather than “half empty,” primarily because China had made massive efforts to adjust its laws to make them compatible with WTO requirements and to train large numbers of relevant government officials in the concepts and practices implied by WTO membership, and because China had

acted effectively to reduce its tariffs as required by its WTO accession commitments. I also noted that a number of “Year One” commitments had not been fully implemented, and commented that for this and other reasons, “Year Two” would prove to be a critical point in the multi-year process of full implementation laid out by those WTO accession agreements.

Before turning briefly to report on what the Council perceives as Year Two winds down, let me offer a couple of contextual comments.

First, it is important to note that overall U.S.-China business has grown extremely rapidly in 2003, and that China, whose economy has been advancing (in spite of the SARS crisis) at a torrid pace, is both importing from and exporting to the world in massively increased volumes. Chinese government statistics show Chinese exports in the first quarter of 2003 up by 33 percent over the same period in the preceding year, and Chinese global imports up by a remarkable 52%. The same statistical source shows that China’s global trade balance the first quarter of 2003 was negative by a billion dollars, as compared with a positive balance of over seven billion dollars a year ago; full-year 2002 balance was positive by \$30 billion, and it will be interesting to see how full-year 2003 shapes up.

Chinese figures show the United States ranked second (to Japan) among China’s trade partners, with first quarter 2003 total trade up 35.8 percent over the preceding year. American official figures, which are generally understood to understate U.S. export totals to China (while Chinese figures are regarded as overstating similar categories) nonetheless show U.S. exports in the first quarter of 2003 up 38% over the same period in 2002, and U.S. imports from China (generally regarded as overstated in U.S. statistics) rising by more than 31%. Such export categories as iron and steel (up 81.4% year-on-year), oil seeds (up 181% YOY), organic chemicals (up 132%), and medical equipment (up nearly 45%) are indicators of a very strong American export performance with China.

In short, in a period of sluggish economic performance throughout much of the world and certainly in the United States, U.S. trade with China has expanded very robustly over the past year. The driver of this expansion has been the high rate of Chinese economic growth. More vigorous U.S. economic expansion would stimulate further growth in bilateral trade, as it would U.S. bilateral trade with many partners, though much of that growth could be expected to show up on the import side. Analysts of China’s economy, both within and outside the PRC, have begun to express concerns about economic overheating in China, characterized by a huge burst of bank lending and the resumption of nearly uncontrolled expansion in the real estate and construction sector—and accompanied by a massive inflow from abroad of money, presumably in expectation either of RMB revaluation or other forms of higher return than are perceived to be available overseas. Whether this amounts to a serious threat to the continuation of China’s rapid growth, whose perpetuation at some level is still considered a critical prerequisite to the management of China’s massive problems of economic restructuring and both agricultural and urban unemployment, remains to be seen, but a significant drop in growth rates would very likely have negative effects on U.S. exports to the PRC.

Against this background of rapidly expanding bilateral trade, the Council’s evaluation of China’s WTO record in Year Two is nonetheless, and regrettably, very qualified.

I would say that there are signs that China and the U.S.—indeed, China and many of its fellow WTO members—may be falling into a pattern of engagement over WTO that football fans would call a “yard by yard ground game,” in which progress toward decisive implementation of critically important WTO principles and specific sectoral commitments pulses unevenly up and down the field, perhaps in a generally favorable direction, but laboriously, with setbacks, diversions, “Time Out” periods, “fumbles,” and only very rarely a “long ball” play that scores quick, major gains in the move toward the clearly defined goal lines.

The most worrisome aspect of this apparent loss of clear momentum in regard to fulfillment of China’s WTO obligations is that, in both countries, the possibility of being “nibbled to death” by reciprocally destructive actions aimed at protecting one or another economic interest or sector could take on a momentum of its own that gradually undermined each country’s confidence in the good will of the other and thus became a self-fulfilling negative trend. Certainly, as we know so well, a minor forest fire of specific and generalized complaints about China’s economic and trade demeanor as it affects the United States continues to flare in this country. While the U.S.-China Business Council believes that the Administration has generally handled this sensitivity in a judicious and constructive manner, we remain concerned that failure to progress decisively on key WTO commitments in China could itself become the product of tit-for-tat frictions between the United States and China

in a period of high political sensitivity, and that a clear sense of “first cause” will be replaced by a downward spiral of reciprocal irritation and blame.

The Council’s written submission, however, focuses on the subject at hand, China’s overall record on WTO implementation in Year Two. It finds that on tariff reduction, China has acted effectively. To treat this quickly is not to diminish its significance; WTO-defined tariff reductions are unquestionably a factor in the vigorous expansion of U.S. exports to China. but we need not spend a long time discussing it.

On other key areas, the record is less laudable. From our corporate respondents, we learn that transparency—the ability of affected foreign economic actors to view and understand the processes by which laws and regulations affecting them are developed and enacted—remains a very serious problem, albeit of uneven gravity across the spectrum of Chinese government ministries and other agencies. The perception that structural problems within the Chinese government, and in particular the difficulty in determining which agencies have decisive influence over which other agencies in advancing the WTO-mandated agenda of policy and regulatory liberalization, continue to hobble China’s WTO progress has become, if anything, more entrenched among U.S. corporate actors in the PRC over the past year. (A charitable view of this, perhaps not held by many of our respondents, would be that the installation of a new national government administration in the spring, at exactly the moment when the SARS epidemic struck with crippling effect in Beijing, might have contributed to this apparent weakening of government resolve on key WTO implementation issues, but there is simply no way of measuring this, and in the end the terms of the WTO commitments are clear).

In a broad sense, perhaps the greatest concern we see is that regulatory measures adopted in apparent response to WTO requirements create new and daunting obstacles to the actual expansion of international business opportunities in the PRC. Our respondents consider this to be a clear indication of out-and-out protectionism on the part of government bureaucracies defending their bureaucratic prerogatives and the economic interests of their domestic constituencies—a phenomenon hardly unknown elsewhere in the world, but one which takes on a particularly odiferous quality when absolutely crucial WTO commitments seem thus to be derailed or delayed. It is this regrettably recurrent phenomenon of regulatory diversion that constitutes, overall, the most irritating and worrisome aspect of China’s WTO progress in Year Two. The inability to resolve, cleanly and decisively, a series of issues that have festered for too long, now, is contributing to a sense of cynicism among those firms, in those sectors, directly affected. Our written submission goes into some detail on this, and we welcome discussion with our respected counterparts in the U.S. Government.

Members of the TPSC, to the surprise of many observers, U.S.-China relations overall have, in the past two years, turned in a very favorable direction. The United States and China are apparently working well together, publicly and privately, on a variety of issues of the greatest sensitivity and the greatest significance for the security of the United States and the world. The range of bilateral cooperation efforts at the government to government level has increased. Contacts and reciprocal visits at the highest levels of our two governments have become almost routine, in ways that can only benefit the profoundly important cause of mutual understanding on complex and difficult issues in world affairs. The U.S.-China relationship over the past two years has truly become “normal,” after years of acute and highly volatile friction and conflict. Against that backdrop, the continued expansion of our bilateral trade and economic relationship is both to be expected and a logical contributor to a “virtuous circle” of continually improving relations.

The positive contribution of expanding trade and economic relations to a more stable and mutually beneficial overall relationship between the U.S. and China, however, is not automatic. The rapid emergence of China on the global economic scene as a trading power and a manufacturing center is, in fact, a historically important development that poses dilemmas both for the world’s economies unaccustomed to the new Chinese position and, indeed, for China itself. Complex and difficult social and economic adjustments are in train, not least in China, whose commitment to integration in the global economic mainstream has its own potentially dire domestic consequences.

We are, in other words, in a period of considerable delicacy and sensitivity. The U.S.-China Business Council believes that the value of the World Trade Organization lies primordially in its ability to mediate and stabilize relations among widely disparate economies and societies, by defining commonly agreed-to standards of economic and commercial behavior for all members’ governments to follow and by defining impartial, multilateral formats for the resolution of otherwise unresolvable disputes.

For this system—which is in everyone’s interest—to work effectively, it must be embraced decisively. We don’t pretend, like Voltaire’s *Candide*, that “Everything is for the best in this best of all possible worlds;” nations have their interests to defend both bilaterally and in multilateral fora. But the U.S.-China Business Council, in its very qualified assessment of China’s progress toward full implementation of its WTO commitments during the second year of its membership, is concerned that the defense of national, local and sectoral economic interests, should it continue to erode China’s ability to realize its WTO obligations in a manner that its trading partners clearly acknowledge, will at the very least prevent China and the world from grasping the full benefits of China’s entry into the WTO. It is absolutely critical that China’s WTO track record not become the starting point for a progressive degeneration of economic and commercial relations between the U.S. and China, to say nothing of a more widespread erosion of trust and cooperation. While there is plenty of room for mutual recrimination in such a darkening scenario, the Council believes that the content of China’s WTO accession agreements is, in fact, generally very clear and very specific, and that China’s progress toward fulfillment of those agreements is China’s responsibility—both to accomplish, and to show clearly to the world trade community. We thank our counterparts in the Office of the U.S. Trade Representative, the Department of Commerce, and other agencies of our government for their extensive efforts to ensure amicable and full compliance on the part of the People’s Republic of China, while resisting inevitable pressures to protect highly particularistic interests within our own country. We predict, however, that your work is far from finished. Thank you again for the opportunity to introduce our Council’s written findings today.

Appendix 2 to Robert Kapp’s Testimony

An Assessment of China’s Second Year of WTO Membership Prepared on September 10, 2003

The U.S.-China Business Council (USCBC) is pleased to provide the Office of the U.S. Trade Representative (USTR) with the following assessment of China’s compliance with its WTO commitments in its second year of WTO membership. Issues related to China’s WTO entry have been integral to USCBC work for more than a decade as part of broader efforts to help U.S. member companies succeed in the China market. The Council has systematically tracked implementation efforts since China acceded to the WTO on December 11, 2001, and the Council’s WTO Working Group has met quarterly since that time to discuss problems and progress. This report is not intended to be comprehensive, but rather to highlight for USTR key developments of particular significance to USCBC members.

I. EXECUTIVE SUMMARY

Important new market openings scheduled for 2003, together with outstanding problems that arose during China’s first year of WTO membership, make year two especially significant for foreign companies operating in China. A range of WTO-mandated tariff reductions took effect relatively smoothly on January 1, 2003, but China must still implement a number of important commitments on market access in services by December 11, 2003 (see Annex). Of critical concern is how China will allow foreign firms to expand their scopes of business in ways necessary to the full realization of WTO-mandated trading and distribution rights. According to China’s WTO commitments schedule we should be at least half way toward the realization of trading and distribution rights, with full implementation to take place by December 11, 2004. Unfortunately, to date, China has only granted export sourcing rights and the right to establish minority trading joint ventures—an apparent contravention of China’s terms of accession, which dictate that no specific form of incorporation would be required to trade by December 11, 2004.

The inability of government ministries in China to reach policy consensus, and the enactment of questionable policies for the apparent purpose of protecting domestic interests, have slowed the pace of implementation and emerged as serious problems. The newly established Ministry of Commerce (MOFCOM) and its predecessor, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), have made considerable efforts to coordinate and implement WTO commitments, yet have run into trouble forging consensus among competing agencies on more than one occasion. In other instances, U.S. companies have faced outright protectionist policies implemented by PRC government officials. The formation and growing activism of quasi-governmental industry associations in the most protected industries is cause for concern. These groups represent powerful protectionist constituencies before the PRC government on issues such as standards setting. Companies note that many PRC

government officials and business executives see WTO commitments as the maximum that can be offered, rather than a minimum level of openness to foreign investment and trade. Implementing regulations in many sectors, in defining the terms of access, delay or severely restrict foreign participation.

In July and August 2003, USCBC conducted a survey of member company views on China's implementation of its WTO commitments to date. On a scale of 1 (excellent) to 10 (failure), USCBC members gave China an average unweighted score of 5.2, the academic equivalent of a C, on its implementation efforts so far. In their responses, USCBC members noted some progress during year two in the areas of transparency, intellectual property legal framework and structure and enforcement, as well as tariffs and standards. Members cited trading rights, distribution rights, and nondiscrimination and national treatment as areas in which there has been a pronounced lack of progress or, in which new problems have appeared.

When asked to identify the major obstacles to WTO implementation in their priority areas, a majority of firms identified "government protectionism" and "industry protectionism" as the two main obstacles to progress. Respondents also highlighted inadequate access to China's rulemaking process as a significant barrier to effective market access. Low levels of understanding among PRC government officials was not seen to be a problem except in the areas of customs/trade administration and transparency. A lack of resources was perceived to be a significant barrier only in intellectual property rights enforcement.

II. YEAR ONE HOLDOVER ISSUES

Tariff reductions appear to be occurring satisfactorily. For certain products, China has lowered tariffs ahead of the WTO schedule. China has also done a relatively good job of issuing and revising legislation to meet its yearly commitments. Extensive bilateral discussion has resulted in limited progress on some year-one issues, but contentious issues such as express mail, tariff-rate quotas (TRQs), insurance branching, high capital requirements in services, and genetically modified organism (GMO) policy are far from resolved.

Agricultural and industrial quotas and tariff-rate quotas

PRC regulations announced industrial quota amounts for 2003 import quotas on autos, tires, rubber, and crude or processed oil that meet or exceed minimum WTO commitments. Auto quota allocations that were left over from 2002 were partially extended to 2003. China lifted quotas for motorcycles and crane lorries and chassis on January 1, 2003, one year ahead of schedule. Yet, China still maintains separate catalogues of products that require registration or import permits in direct violation of the WTO national treatment principle. China has yet to release comprehensive implementing regulations for quota allocation, and the process remains opaque.

In agriculture, complicated import licensing procedures still pose barriers for U.S. firms. China maintains a distinction between products imported under normal trade for domestic consumption and those imported under processing trade for export. The distinction allows for quota to be allocated for processing-trade purposes on a first-come, first-served basis. This violates WTO national treatment principles because it gives preferences to products not bound for the domestic market. Progress so far has been limited in spite of significant pressure from U.S. industry and the U.S. Government. China needs to issue all of its allocated TRQs to a variety of qualified users in a timely manner.

China also requires firms to obtain import licenses to receive shipments of certain products even after they have received quota allocations. And China refuses to provide information about companies that have received a quota allocation and the amount that has been allocated, preventing exporters from identifying eligible importers. Companies in several industry sectors continue to report problems of state companies receiving non-state allocations.

Agricultural GMO standards and SPS measures

Investment provisions detailed in 2001 foreign investment rules constitute a retreat from earlier market-access provisions and restrict U.S. companies from investing in China's agricultural biotechnology sector. U.S. companies are pleased that China extended GMO certificates until April 2004 under the temporary administrative regime for GMO imports. New sanitary and phytosanitary (SPS) measures target imports of soybeans, however, and threaten U.S.-China agricultural trade.

High capital requirements for services

Foreign service firms in many industries face unreasonably high capital requirements to establish a commercial presence and to establish branches and sub-branches in a variety of services. These include banking, insurance, logistics, and telecom services. China's recent insurance implementing regulations significantly reduce capital requirements from earlier draft regulations, but the amount of money required to establish and branch is still much higher than levels in most other countries.

Auto finance regulations

While USCBC sources indicate regulations may be released before the end of 2003, as USCBC goes to press, auto finance rules have yet to be finalized and issued. The rules are already almost two years late.

Value-added, consumption, and border taxes

China revoked preferential tax policies enjoyed by 20 border-trade products on June 1, 2003. The move is an important step toward treating goods imported through normal trade and border trade equally, although China has not abolished preferential treatment for all products traded on the border. Preferential treatment for integrated circuit (IC) products manufactured in China continues to discriminate against IC imports. Similar value-added tax (VAT)-related complaints have been raised with regard to fresh and live seafood, corn, and fertilizer.

III. YEAR TWO ASSESSMENT OF PRIORITY ISSUES

The following issues are discussed in order of importance to USCBC member firms. In USCBC's recent survey, each responding company was asked to select five priority issues from a list of 23 choices. The following 11 issues emerged as the most important concerns for USCBC firms in the order listed. Issues received a weighted score to reflect their relative importance to respondents. The score was calculated according to the number priority indicated by each member firm according to the following scale: Priority 1=5 points; Priority 2=4 points; Priority 3=3 points; Priority 4=2 points; Priority 5=1 point.

Issue	Weighted Score
1. Trading Rights (ability to import and export product)	112
2. Transparency	106
3. Distribution (ability to distribute product to wholesalers, retailers, and end users within China)	97
4. Standards, Technical Regulations, and Conformity Assessment	96
5. Intellectual Property Rights (IPR): Enforcement	85
6. Non-Tariff Measures (quotas, licenses, tendering requirements)	79
7. Tariffs	76
8. Specific Market-Access Service Commitments	73
9. Non-Discrimination/National Treatment	61
10A. Customs and Trade Administration (classification, valuation, rules of origin)	57
10B. IPR: Legal Framework (patent, trademark, copyright)	57

1. Trading Rights (See Distribution Rights below)

Trading and distribution rights in China are in flux. Some regulations have been issued, but companies are uncertain about how full trading and distribution rights will be implemented by December 11, 2004. In lieu of regulatory clarity, most companies have contracted with trading companies or thirdparty logistics companies to handle portions of the chain that require specific licenses and have used trading companies located in Shanghai's Waigaoqiao free trade zone to import, store, and manage products. Of particular concern are signs that China may seek to restrict the scope of these rights by product area.

China committed to allow existing foreign-invested enterprises (FIEs) to obtain full trading rights (beyond import as inputs or for self-use) for almost all products over a three-year phase-in period. Joint venture enterprises with minority-share equity were to have been granted full trading rights as of December 11, 2002. Although MOFTEC (now MOFCOM) published provisional regulations in February 2003, the new regulations do not address how existing FIEs in which the foreign investor has a minority stake may obtain full trading rights. They also do not move far enough toward the December 11, 2004 deadline by which time trading rights are to be allowed via notification and without the imposition of any additional investment or approval requirements.

2. Transparency

China's uneven implementation of its commitments regarding transparency remains a particular disappointment for foreign firms. Transparency is an issue that affects all firms; it is among the most important of China's WTO commitments.

The WTO requires new regulations to be subject to a period of public comment before they take effect. But in China, public comment periods for new rules are still not universal and when a government agency does provide one, the comment period is often too short to be useful. For example, China did not publicly issue its draft revisions to the 1994 auto-policy guiding rule and did not provide an opportunity for foreign companies to comment. And although foreign investors understand that draft rules on retail, franchise, or direct selling have been completed, the regulations have not appeared publicly.

The first transitional review mechanism (TRM) process in fall 2002 failed to reach the expected level of transparency from the Chinese delegation. While China has been reasonably responsive to specific requests for information in committee meetings in Geneva since the first TRM and seems to prefer this format, it is important that China remain responsive to requests for information and report on changes to its laws, regulations, and procedures. Failure to use the WTO consultative mechanism in committee meetings throughout the year and at the TRM, combined with problems on implementation, is likely to result in heightened pressures for unilateral action on trade disputes with China from within the U.S. Congress and affected U.S. industry and for multilateral action within the WTO's dispute resolution process.

3. Distribution Rights

A key outstanding issue is how imported products may be distributed in China. For U.S. companies, trading and distribution rights are fundamentally interrelated. Having rights in one area without the other does little to help a company establish an integrated supply chain logistics operation. U.S. companies hope that China will implement trading and distribution rights in tandem and that new rules will enable companies to integrate these two components into their overall operations. Unfortunately, PRC officials have stated so far that they intend to implement trading and distribution rights completely separately and without consideration for how the rights are fundamentally interrelated within a company's operations. Many companies are concerned that China may require separate distribution channels for imported and domestic products.

As it stands today, any FIE in China may distribute only the products it manufactures in China and may provide after-sales services only for such products. China maintains that only companies with a specific distribution license may distribute third-company products or imported parent company products, regardless of whether the company has trading rights. Only FIE holding companies may, with specific approval, distribute small quantities of imported products for market testing (though a March 2003 rule change allows holding companies to provide after-sales services for all imported parent-company products). China may try to link distribution rights to a company's scope of business. USCBC discussions with PRC regulators indicate that China is considering rules that would allow existing FIEs to import and distribute products within a specific industry but not across industries. For example, a pencil manufacturer could import and distribute pencils but not automobiles. It is not yet clear whether such FIEs would be limited to distributing parent company products or if they would be able to distribute other companies' products as well.

China issued the July 2002 Notice on Relevant Issues Regarding the Experimental Establishment of Foreign-Invested Logistics Companies, which technically meets China's commitments to allow distribution companies with foreign minority investment by December 11, 2002. But China has yet to define how existing FIEs may expand the scope of their current operations to include distribution. The July 2002 notice allows existing FIEs to apply to have logistics added to their business scope, but China has not issued implementation rules to detail such procedures. According to the July 2002 notice, foreign-invested logistics companies must have registered capital of \$5 million.

4. Standards, Technical Regulations, and Conformity Assessment

U.S. companies have expressed frustration about their lack of access to China's standards-setting process in a variety of sectors. Currently, no formal mechanism exists for foreign companies to participate in the development of standards in China. The standards development process is opaque, and comment periods on pending standards, when offered, are too short to allow meaningful comment.

China does not recognize standards certification and testing that takes place outside of China. China also has yet to implement the regulatory framework necessary to allow foreign-invested testing and certification organizations to conduct conformity assessment services for the domestic market. Majority-owned ventures are to be allowed in this area by no later than December 11, 2003.

Greater coordination is still needed between the State Administration of Quality Supervision, Inspection, and Quarantine (AQSIQ) and PRC Customs. Since China implemented new “CCC” (China Compulsory Certification) mark requirements on August 1, 2003, U.S. companies have reported inconsistent application of the new rules. Shipments of imported products not requiring a “CCC” mark have been denied entry, adding expense and delay. Domestic products required by law to display the “CCC” mark but that are without it are still readily available through normal commercial sales channels.

5. Intellectual Property Rights: Enforcement

10.B Intellectual Property Rights: Legal Framework

USCBC concurs with USTR’s Special 301 report assessment in 2003 that China has failed to enforce patent, trademark, and copyright protections effectively. Lack of transparency and coordination among government agencies, local protectionism and corruption, high thresholds for criminal prosecution, and lack of training all hinder enforcement. Though China has made important efforts to combat copyright piracy and trademark counterfeiting in the area of legislation, piracy and counterfeiting at the wholesale and retail level, and over the Internet, remain rampant due to inadequate penalties; uncoordinated enforcement among local, provincial, and national authorities; and a lack of transparency in China’s administrative and criminal enforcement system. The piracy rate for optical media products is reported to be well over 90 percent.

6. Non-Tariff Measures (quotas, licenses, tendering requirements)

As discussed above in “Year One Holdover Issues,” companies face difficulties regarding quota allocation and the administration of TRQs. The TRQ administration process entails burdensome licensing requirements and procedures for obtaining and using a TRQ allocation. Quotas are allocated in unviable quantities, and a portion of quota is still reserved for use in export-processing trade. China maintains a complex matrix of rules governing the licensing of such imports as general commercial goods, mechanical-electrical products, goods subject to designated trading, and technology products. Catalogues have up to four classification categories: free import (no restrictions); automatic licensing; restricted; and prohibited. Further breakdowns distinguish goods according to their type and use. Despite efforts by negotiators to clarify the process, the system remains opaque and cumbersome. The 2003 mechanical-electric product quota management rules announcement was particularly opaque and indicates that problems in this area still need to be addressed. Localization mandates in China’s draft auto policy provide incentives for auto companies to procure high-value parts locally instead of importing them.

7. Tariffs

10.A. Customs and Trade Administration

Tariff reductions appear to be occurring on time, but as tariffs fall, some companies are reporting new problems emerging in the areas of valuation, VAT, and licensing that affect the cost and ease of importing products. For example, China made commitments to value digital products according to the value of the underlying carrier medium rather than the imputed value of the content (i.e. on the basis of projected royalties). In June 2003, however, China issued regulations that call for valuation according to the imputed value of content, not according to the value of the underlying carrier medium.

China announced in late December 2002 that it had reduced tariffs, as required, on 7,445 eight-digit Harmonized Schedule (HS) codes. Tariff cuts that took effect January 1, 2003 reduce China’s average rate on an unweighted basis to 11.1 percent.

The problem of end-use certification for 15 products covered under the Information Technology Agreement (ITA) has been addressed by a compromise that transfers authority for issuing end-use certificates from the Ministry of Information Industry (MII) to China’s General Administration of Customs. During a review period, U.S. officials will examine whether U.S. companies are adversely affected under the new system. After this period, complaints will be lodged within the ITA framework at the WTO.

8. Specific Market-Access Commitments in Services

While half of USCBC survey respondents reported some progress in market access, an equal number of respondents reported no progress or the emergence of new problems in this area. The major problem emerging in services appears to be a two-layered approach by PRC regulators. Basic laws are enacted that “allow” or “permit” for new investment in previously restricted sectors as required by WTO commitments, but the terms of entry are prohibitively high or cumbersome. In effect these rules curb market access for all firms and especially for smaller firms. Delays in licensing have also prevented companies from establishing or expanding operations. Ambiguity about core commitments, such as how to branch or sub-branch in insurance or how to define telecommunications value-added services (VATS) are also preventing forward movement in services.

Construction and Engineering

The Foreign-Invested Construction Enterprise Management Rules, which took effect on December 1, 2002, allow for the establishment of wholly foreign-owned construction enterprises (WFOCEs) two years ahead of China’s commitment schedule. The rules require domestic parties to contribute at least 25 percent of registered capital in joint ventures. As outlined in China’s WTO commitments, the rules restrict WFOCEs to wholly foreign-financed projects and Sino-foreign projects with majority foreign investment. Foreign companies in the engineering and construction sector are concerned about the timing and commercial implications of new construction enterprise regulations, Ministry of Construction Decree 113 and (114, which has not been formally issued). The timing between the repeal of existing regulations and enactment of the new measures would create a regulatory gap, forcing current operators to operate illegally during the interim period. Draft regulations threaten to retreat from practices allowed prior to WTO entry. Concerned parties have not had an adequate opportunity to discuss with PRC regulators how to bring the rules closer to international practices.

Insurance

Revisions to the Insurance Law took effect January 1, 2003. One revision removes the requirement in Article 101 of the 1995 law that 20 percent of underwritten contracts be reinsured with the China Reinsurance Co., thereby meeting China’s WTO commitments to lower the compulsory cession level by 5 percent each year beginning December 11, 2002. Article 91 of the 1995 law was also revised to allow both life and non-life insurers to sell shortterm health insurance and accidental injury insurance, though the prohibition on operating both life and non-life insurance business remains. High capital requirements to establish and branch and ambiguity on how to branch and sub-branch continue to be important obstacles for the industry, especially as firms apply to provide services in a new range of cities scheduled to open to foreign life and nonlife insurers and insurance brokers by December 11, 2003: Beijing, Chengdu, Chongqing, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan, and Xiamen.

Legal services

The Ministry of Justice approved on December 16, 2002 the establishment of a second office for 11 law firms that already have one office in China. China had committed to lift restrictions on the number of offices a law firm could establish within one year of its WTO entry.

Logistics

China adopted the Rule on the Administration of Foreign-Invested International Freight Forwarding Agent Enterprises on January 11, 2003, replacing a December 2001 rule by the same name. The rule is notable for its translation of the WTO commitment to allow “majority foreign investment” into an arbitrary 75 percent cap on foreign investment. Many in the sector had hoped China would not cap foreign investment.

Telecom services

China’s commitments to expand geographic access and to allow 50 percent foreign equity in value-added telecom and paging services by December 11, 2003 remain unrealized because of vague regulatory guidelines and a failure to license firms in these new areas. MII’s revised Catalogue on Telecommunications Services Classification, issued in March 2003, remains an obstacle to foreign investment because it does not define which items within the revised VATS section are open to foreign investment. MII officials have maintained that the

VATS operations listed in China's WTO commitments are exhaustive and that not all VATS operations are open to foreign investment.

9. Non-Discrimination and National Treatment

This core principle of WTO membership remains a fundamental problem for firms in China across a wide range of sectors. A majority of USCBC firms report no progress in this area. Both government protectionism and industry protectionism are seen to be the main obstacles to realizing equal treatment for foreign and domestic products and services. In particular, China's VAT regime favors domestic products over imports; import-licensing procedures favor goods bound for export processing over those bound ultimately for the domestic market. Many of the problems highlighted above indicate that PRC policies continue to offer domestic companies more favorable treatment. This entrenched problem will require significant efforts that focus on each problem area in order to attain fair treatment for foreign goods and services in China.

V. LOOKING AHEAD

The PRC government has been slow to implement its most significant commitments, and in some important areas, efforts now appear stalled. Recent trends indicate that China has fallen into a pattern of re-negotiating its WTO entry terms line by line as questions are raised about implementation problems. Restrictive terms and new barriers threaten to negate the very terms of access to which China has committed.

In 2002, impending senior-level Chinese Communist Party and government leadership transitions and intra-bureaucratic difficulties impeded progress. In 2003, adjustments related to the new MOFCOM and the outbreak of Severe Acute Respiratory Syndrome (SARS) stymied progress. USCBC believes that China should act now to resolve outstanding issues and to meet year-two commitments by December 11, 2003 to maintain the international community's faith in both China's intent and ability to honor its WTO obligations.

Implementation of these commitments does not only entail enactment of new provisions that announce the opening or liberalization of a particular area. To be meaningful, implementation also requires detailed rules and procedures that reflect the full terms and spirit of China's WTO accession agreements and ensure that market access as negotiated is allowed in fact.

Now, almost two years into China's WTO membership, USCBC has observed that the source of many of the problems discussed in this testimony rest with agencies belonging to the central government in Beijing, not at the local level. The main obstacles to implementation are government protectionism and industry protectionism; minor obstacles include a lack of understanding or resources. It is up to China's central government to apply pressure internally, if necessary, to make sure its agreements are fully implemented. If implementation continues to stall, as we enter the critical juncture of year three of China's membership, USCBC supports the strongest efforts by USTR in direct contact with China's leaders at the highest levels to eliminate these difficulties before they do further damage.

China is now a WTO member. USCBC and its members are watching closely for a cooperative transitional review process this year, expecting to see improved responsiveness from the PRC delegation. USCBC is also watching the lead up to the fifth WTO Ministerial Conference to be held in Cancun, Mexico, with great interest, as China begins to demonstrate what type of WTO member it will be. Preliminary indicators show that China is at odds with the U.S. agenda in Doha and appears to prefer a more closed, as opposed to a more open, global trading system as evidenced by its unwillingness to reduce industrial tariffs and its leadership role along with India and Brazil to fight efforts to limit agricultural subsidies and price supports. China's original expression of interest in joining the Government Procurement Agreement has taken on new urgency with recent government directives to procure only domestic software, and USCBC hopes that China will continue to discuss with USTR and other GPA members about how to formally join in the near future. USCBC hopes that recent statements are not indicative of future positions and that in short time China understands what is at stake in the Doha round and joins the United States and others in working toward further trade liberalization.

Annex: China's Year-Two Services Commitments

China must meet the following WTO commitments in services by December 11, 2003:

Advertising

Permit foreign majority ownership in advertising firms

Banking

Allow foreign financial firms to provide local currency services in Chengdu, Chongqing, Fuzhou, and Ji'nan and local currency services to Chinese enterprises

Commission agents and wholesale

Allow foreign majority ownership and no geographic or quantitative restrictions for foreign service suppliers of most imported and domestically produced products (with some exceptions)

Freight forwarding

Provide national treatment for additional registered capital requirements for joint ventures (JVs); allow foreign freight forwarding agencies to set up a second JV after a first JV has been in operation for two years

Insurance

- Permit wholly foreign-owned subsidiaries of foreign nonlife insurers
- Reduce to 10 percent the mandatory cession to China Reinsurance Co. of all lines of primary risk for nonlife personal accident and health insurance business
- Allow foreign life and nonlife insurers and insurance brokers to provide services in Beijing, Chengdu, Chongqing, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan, and Xiamen
- Permit foreign nonlife insurers to provide the full range of nonlife insurance services to both foreign and domestic clients
- Reduce insurance brokers' asset requirements to \$300 million

Retailing

- Permit foreign majority ownership in JV retailing enterprises
- Open all provincial capitals, plus Chongqing and Ningbo, to JV retailing enterprises
- Permit foreign service suppliers to retail all products, except for books, newspapers, and magazines

Technical testing and analysis and freight inspection

Permit foreign majority ownership, except in statutory inspection services for freight inspection services

Value-added telecommunications and paging

Eliminate geographic restrictions and permit foreign investment at 50 percent

SOURCE: Protocol on the Accession of the People's Republic of China, Annex 9: Schedule of Specific Commitments on Services Year Two Services Commitments.

Appendix 3 to Robert Kapp's Testimony**WTO: China Enters Year Three****China has many new commitments to fulfill—and some catching up to do—during its third year as a WTO member**

by Julie Walton, in *The China Business Review*, vol 31, no. 1 (Jan.-Feb. 2004), pp. 10–15 and 37.

Julie Walton is associate, Business Advisory Services, in the U.S.-China Business Council's Washington, DC, office.

China began its third year as a World Trade Organization (WTO) member on December 11, 2003. That day, the clock started ticking on China's year-three commitments under its Schedule of Specific Commitments on Services—and all year-two commitments were to have been in place. On January 1, 2004, WTO-mandated tariff reductions for goods took effect.

But two years into China's WTO membership, the PRC government has been slow to implement its most significant commitments, and no progress has been made in some important areas. China has fallen into a pattern of renegotiating its WTO entry terms line by line as questions arise about implementation problems. China's interpretations of certain WTO terms violate the spirit, if not the letter, of its commitments, and new barriers China has erected in some areas make matters worse. Will China be able to pick up the pace in year three—a year with a heavy schedule of commitments and high expectations for rules in many areas, including trading rights and direct selling?

More service commitments to phase in

China's commitments to expand foreign participation in services are of major importance to foreign service providers in all industries. Though some year-two commitments remain outstanding (*see* **Box 1**), China must implement a range of new commitments before December 11, 2004. China is expected to issue a series of new regulations in the coming months to address these requirements.

- **Trading rights**

Foreign companies' right to import and export goods—a key element of all WTO agreements—has been a weak spot in China's implementation efforts. Joint ventures with minority foreign stakes should have been granted full trading rights by December 11, 2002. But regulations that conferred this right did not appear until February 2003 and were so vague that companies found it difficult to structure their operations. The rules did not clarify how existing foreign-invested enterprises (FIEs) could obtain trading rights, nor did they state that the granting of trading rights would be automatic. Meanwhile, in June 2003, China granted full trading rights to all enterprises, including FIEs, in Futian-Shatoujiao, Tianjin, Waigaoqiao, and Xiamen Xiangyu free-trade zones.

Further progress appears close at hand. In November 2003, the State Council approved revisions to the Foreign Trade Law. As the *CBR* went to press, details of the revised Foreign Trade Law had not yet been released, but there are indications that the procedure for granting import and export rights will be revised to eliminate the examination and approval process, as China's WTO commitments require. The new process will simply involve filing an application with relevant authorities, after which import and export rights will be added to the scope of existing business licenses. But because the National People's Congress was scheduled to meet at the end of December—after the December 11, 2003 deadline for China to grant majority-owned joint ventures trading rights—this deadline passed without the issuance of corresponding and vital implementing rules.

China also committed to allow domestic companies increased access to trading rights by progressively lowering registered capital requirements. In year three, the required registered capital for domestic Chinese trading companies should fall from \$360,000 in year two to \$120,773.

- **Distribution and related services**

China has agreed to implement a number of important commitments in the areas of retailing, wholesaling, and commission agents' services, and franchising by December 11, 2004. Although a year late, a recently circulated draft of the Ministry of Commerce's (MOFCOM) Management Regulations on Foreign-Invested Commercial Enterprises may finally bring China up to date with many of its distribution-related WTO commitments and put it on track to meet its December 11, 2004 obligations. The draft covers Sino-foreign equity/cooperative joint ventures or wholly foreign-owned enterprises engaged in domestic retail, wholesale, commission agents', or franchising businesses. Though the draft does not clearly state whether an existing FIE can obtain distribution rights, it allows FIEs to establish companies to distribute their imported or China-made products. The draft also does not address direct selling, which China's WTO commitments define as one type of distribution service; MOFCOM is drafting a separate rule to address this industry. The draft regulation must be submitted to the State Council for final approval. The State Council has not yet indicated when it will issue the regulation.

Observers note that China's recent WTO implementation actions have rested with agencies under the central government in Beijing, not at the local level as some have speculated.

Retail.—China has agreed to allow foreign majority control of retail operations by December 11, 2003 and to allow wholly foreign-owned enterprises (WFOEs) by December 11, 2004. Majority foreign investment in chain stores with more than 30 outlets will remain prohibited until 2006. All remaining geographic restrictions covering China's retail sector should be removed by the end of 2004. China has also agreed to remove remaining product-specific restrictions. In other words, by the end of year three, foreign retailers will be allowed to sell pharmaceuticals, pesticides, mulching films, and processed oil in addition to other goods.

The PRC government made some progress in opening the retail sector in March 2003 when MOFCOM (then the Ministry of Foreign Trade and Economic Cooperation) and the General Administration of Press and Publication (GAPP) published a rule that permits WFOEs in China's retail book, magazine, and newspaper distribution sector. USCBC sources confirm that, in principle, the new rule opens investment in retail distribution of publications ahead of schedule. The new rule requires \$600,000 in registered capital for retail operations, and legal representatives and

professional staff must possess publication distributor qualification certificates issued under existing rules. The new rule also allows for the provision of Internet publication sales, chain stores, and reader's clubs. Foreign investment in existing publication distributors, including state-owned enterprises, is also allowed. In December 2003, Germany's Bertelsmann AG took a 40 percent stake in Beijing 21st Century Book Chain, a nationwide bookseller.

Wholesale and commission agents' services.—Foreign companies are to be allowed to establish wholly foreign-owned wholesale operations by December 11, 2004. The wholesale distribution of books, newspapers, magazines, pharmaceutical products, pesticides, and mulching films, which had previously been restricted, is also to be permitted. The March 2003 rule that opened the distribution of publications does not apply to wholesale operations until December 1, 2004; China must allow investment via all types of ownership for wholesale distribution of publications by December 11, 2004. The distribution of chemical fertilizers and processed and crude oil will remain closed until December 11, 2006.

GAPP appears to be progressing toward the 2004 wholesale operation liberalization deadline. The agency published the Regulation on Administration of Printed Publications, which addresses verification of domestic publishing licenses, registration of printed matter, publication storage and delivery, and disposal of low-quality publications, September 1, 2003. GAPP also authorized Guangzhou-based Wende Guangyun Media Distribution Group as the first private book distributor on September 19, 2003, in line with the September 1 regulation. Prior to that decision, book distribution had been reserved for the State Postal Bureau, Xinhua General Bookstore, and state-run publishing houses.

Franchising.—China committed to lifting all equity, geographic, or quantity restrictions on franchising operations by December 11, 2004. According to the state-run China Chain Store and Franchise Association, rules that would remove existing restrictions are being drafted.

Wholesale or retail away from a fixed location.—Because China has prohibited direct selling, its commitment to remove all equity, geographic, and quantitative restrictions on sales away from a fixed location by December 11, 2004 is significant for companies that use direct selling as their business model. Regulations are currently in the works, though copies have not been widely circulated for public comment.

- **Telecom**

The problems that foreign telecom service providers have faced in accessing China's market should improve in year three as foreign companies will be permitted to establish joint venture operations in domestic or international data services (such as voice, packet- or circuit-switched transmission, and fax) without quantitative restrictions in Beijing, Guangzhou, and Shanghai—though the foreign investment share may not exceed 25 percent. Foreign companies will be able to invest up to 49 percent in mobile voice or data service joint ventures.

After an extended period with no new approvals of foreign investment in China's telecom sector, four Sino-foreign joint ventures were approved in 2003, all of which provide Internet access services.

- **Financial services**

China's WTO commitments required significant openings to foreign investment in the banking, insurance, and securities sectors during the first few years of China's WTO membership. A number of these commitments will phase in during 2004.

Banking.—By December 11, 2004, foreign companies should be able to participate in local currency business in Beijing; Kunming, Yunnan; and Xiamen, Fujian, raising the total number of cities open to this service to 16—up from the 13 cities that were opened before December 11, 2003.

Insurance.—Foreign providers' business scope is to expand in year three to allow FIEs to provide health, group, and pension/annuities insurance to both foreign and Chinese clients. All geographic restrictions will be lifted, and foreign partners in insurance brokerage joint ventures may raise their stakes to 51 percent. All reinsurance companies in China were required to reinsure 10 percent of their primary risk with China Reinsurance Co. beginning December 11, 2003; the requirement will drop to 5 percent by December 11, 2004.

Securities.—Foreign securities houses are to be permitted to establish joint ventures—with a limit of 33.3 percent foreign investment—to underwrite A shares and to underwrite and trade B and H shares, as well as government and corporate debt, in year three. No Chinese intermediary will be required. Foreign companies should be able to establish domestic securities fund management joint ventures, with investment limited to 49 percent in year-three. China's October 2003 Securities Investment Funds Law puts the country on track to fulfill this commitment.

Although China's WTO commitments did not require this liberalization, China launched a qualified foreign institutional investor plan in 2003 that opened China's renminbi-denominated, domestic A-share market to foreign investors. To date, Citigroup Inc., Deutsche Bank AG, Goldman Sachs Group, Inc., HSBC Holdings plc, ING Groep NV, JP Morgan Chase & Co., Morgan Stanley, Nomura Holdings, Inc., and UBS AG are among the foreign companies that have received approval to participate.

Box 1: The Year-Two Waiting Game

As the *CBR* went to press in early December 2003, foreign companies were awaiting signs from the PRC government that the year-two commitments below had been met. (Signs could include new regulations, deal approvals, or other announcements.)

Distribution

The PRC Ministry of Commerce (MOFCOM) began soliciting comments on a draft distribution services regulation in fall 2003; the State Council must still review and approve the draft. Although the draft has not yet been released to the general public, the regulation is likely to allow foreign investors to establish Sino-foreign equity and cooperative distribution joint ventures (JVs) and wholly foreign-owned distribution enterprises to engage in businesses, described as "distribution services" in China's WTO commitments, including domestic retail, wholesale, commission agents', or franchising businesses in China. The regulation, if and when enacted, may fulfill part of China's year-two distribution commitments.

- **Retail (excluding tobacco)**

China must permit foreign majority ownership in JV retail enterprises and open all provincial capitals, plus Chongqing and Ningbo, Zhejiang, to foreign-invested retail JVs.

- **Wholesale and commission agents' services (excluding salt and tobacco)**

China must allow foreign majority ownership and place no geographic or quantitative restrictions on foreign service suppliers of most imported and domestically produced products (with some exceptions).

Other services

- **Advertising**

China must permit foreign majority ownership in advertising firms.

- **Insurance**

China must permit wholly foreign-owned subsidiaries of foreign nonlife insurers (the China Insurance Regulatory Commission allowed this, with certain requirements, in draft implementing rules released in August 2003, but has not yet released the final regulation); and reduce insurance brokers' asset requirements to \$300 million.

- **Freight forwarding**

China must provide national treatment for additional registered capital requirements for JV branches.

- **Technical testing and analysis; and freight inspection**

China must permit foreign majority ownership in freight inspection (except in statutory inspection services), and in technical testing and analysis services.

- **Value-added telecommunications and paging**

The PRC must eliminate geographic restrictions and permit foreign investment at 50 percent.

Tariff-rate quotas and agriculture

China's tariff-rate quota (TRQ) system for agricultural products has, in effect, acted as a nontariff barrier on agricultural imports. MOFCOM and the National Development and Reform Commission published a regulation on the management of TRQs for imported agricultural products in September 2003. Though the regulation

makes China's TRQ allocation process more transparent, problems with transparency, conformity to international standards, and the assessment of value-added tax remain—especially in corn, soybean, and wheat imports.

Trading rights

China must grant foreign majority owned joint ventures full trading rights. The PRC State Council approved a revised Foreign Trade Law in November 2003; the National People's Congress must still review and approve the law. China has not yet released details that would confirm whether the law will fulfill the nation's trading rights obligations.

—USCBC staff

• Autos

China has committed to raise the level of auto manufacturing investment that requires provincial government approval to \$90 million. This act will reduce the number of bureaucratic hoops that companies must jump through to establish manufacturing operations. Though almost two years late, the China Banking Regulatory Commission issued regulations governing foreign nonbank investment in the auto financing sector in September 2003. The price of entry, however, is quite high. Companies seeking to establish new auto finance companies must possess at least β4 billion (\$483.1 million) in assets, and the auto finance company itself must have paid-in capital of at least β500 million (\$60.4 million). Other concerns with the auto finance rules include a prohibition on establishing branch offices, ambiguities in the approval process, and limitations on the scope of activities permitted.

Table 1: Comparison of Import Tariffs on Major Agricultural Products

Product	2001 Rate (%)	2004 Rate (%)
Barley	114	3
Soybeans	3	3
Other Vegetables	30-50	10-15
Citrus	40	12
Other Fruits	30-40	10-13
Dairy Products	50	10-12
Beef	45	12
Pork	20	12
Poultry	20	10
Wine	65	14
Tobacco	34	10

Source: The World Trade Organization.

• Tourism

China accelerated compliance with its WTO commitments in the tourism industry by two years when it issued regulations in June 2003 that permit wholly foreign-owned travel agencies to operate in China. The regulation covers only foreign-majority joint venture and wholly foreign-owned travel agencies established before December 11, 2007, when all geographic, registered capital, and branch restrictions are due to be lifted. Like the Management Regulations on the Administration of Travel Agencies, which opened the sector to minority foreign ownership in early 2002, the new regulation requires foreign-invested travel agencies to have at least β4 million (\$483,092) in registered capital and does not permit foreign-invested travel agencies to open branches. The new regulation also requires the foreign party in a joint venture to have an annual income from tourism of more than \$40 million, a restriction included in China's WTO entry agreement. Unlike the management regulation, the new regulation restricts foreign investors to an investment in one foreign-majority joint venture or wholly foreign-owned travel agency. According to China's WTO commitments, foreign-majority joint venture or wholly foreign-owned agencies cannot be established outside of State Council-approved resort areas and Beijing, Guangzhou, and Shanghai, and Xi'an, Shaanxi—although investment by such FIEs in Shenzhen is now permitted. Though no foreign company has yet been approved to set up a wholly foreign-owned travel agency, German-based Touristik Union International recently became the first foreign company to have a controlling stake in a Sino-foreign travel joint venture.

Table 2: TRQ Import Volume and Allocations to STEs for 2004

Product Fertilizers	Import Quotas (million metric tons)	Allocation to STEs (%)
Product Fertilizers		
DAP	6.25	75
Urea	2.3	90
NPK	3.13	73
Agriculture		
Corn	7.2	60
Rice	5.32	—
—Long rice	2.66	50
—Mid/Short rice	2.66	50
Wheat	9.64	90
Sugar	1.95	70
Cotton	0.89	33
Wool	0.29	NA
Wool tops	0.08	NA
Palm oil	2.7	18
Rapeseed oil	1.13	18
Soybean oil	3.12	18

Notes: TRQ=tariff-rate quota; STE=state-trading enterprises; DAP=diammonium phosphate; NPK=nitrogen, phosphorous, and potassium fertilizers; NA=not available; —=the percent allocated to STEs for each rice type is broken down into long and short grains.

Sources: National Development and Reform Commission, Ministry of Commerce.

- **Repair, maintenance, rental, and leasing**

In 2004, WFOEs are to be permitted in the repair/maintenance and rental/leasing sectors. MOFCOM stated in late October that it would release new regulations before the end of 2003 that permit wholly foreign-owned leasing operations. But MOFCOM also stated that, at first, only a few wholly foreign-owned leasing companies would be permitted to operate in China. Given the high capital requirements the PRC government has mandated in other sectors, China may use this tactic to limit foreign participation again. Meanwhile, Shell Lubricants' Jiffy Lube International and the Shanghai Automotive Industry Corp. signed a letter of intent in October 2003 to form a \$30 million, 50-50 maintenance business venture; China's State Administration of Industry and Commerce must still approve the deal.

- **Other services**

In year three, China's construction, packaging, and entertainment WTO commitments kick in.

Construction.—Although regulations technically opened China's construction sector to WFOEs in November 2002, well ahead of the 2004 deadline, significant implementation problems have emerged in 2003 that render the liberalization virtually meaningless. High capitalization requirements, the potential repeal of laws that qualify foreign engineering and construction companies, and the lack of implementing regulations have stalled sector liberalization. But, according to China's entry documents, the country has until December 11, 2004 to iron out details permitting wholly foreign-owned construction and engineering firms.

Packaging.—China agreed to allow WFOEs to engage in packaging services by December 2004.

Entertainment.—In early October 2003, China approved Warner Brothers International Theaters, Inc. to take a 51 percent controlling stake in its upcoming joint venture with the Shanghai Cinema Group, which will build and operate 10 cinemas. In accordance with the WTO's Most Favored Nation principle, this deal effectively opens the door to foreign majority ownership in theater management, though China only committed to allow foreign minority shares in its services agreement.

In a related move, China's State Administration of Radio, Film, and Television issued a regulation in October 2003 that permits foreign investment in film production and film-technology companies beginning December 1, 2003. Foreign investors are permitted to hold controlling shares in film technology ventures in certain provinces and cities and foreign partners may take stakes of up to 49 percent in film production companies.

Tariffs and quotas

With the exception of certain agricultural goods, natural resources, and products under quota or license management, all imported goods reached their final bound duty rate on January 1, 2004. Most of China's agricultural products reached their final bound rate on January 1, though import licensing and quota restrictions remain (see Tables). The average agriculture tariff in 2004 is 17 percent.

Tariffs on the import of complete vehicles dropped on January 1, 2004 to 34.2–37.6 percent, down from last year's tariff range of 38.2–43.0 percent. The import quota for autos and auto parts totals \$10.49 billion, meeting China's commitment to raise the 2004 quota 15 percent from 2003.

Tariffs on chemicals also fell substantially. As part of its WTO commitments, China signed the Chemical Tariff Harmonization Agreement, which requires it to lower the average tariff on basic and intermediate chemical products to 5.5 percent and 6.5 percent, respectively, by 2004. In an attempt to meet this requirement, China dropped its tariff on basic chemical imports to zero, thus reducing the average tariff on all imported chemicals to 6.9 percent, down from China's pre-WTO tariff level of 14.7 percent.

The National Development and Reform Commission (NDRC) has confirmed that the import quota distinction between state and nonstate traders of processed oil was eliminated on January 1. Now any domestic company may apply directly to MOFCOM for an import permit.

As part of China's WTO commitments, six categories of goods were initially set aside as "Products Subject to Designated Trading"—a mechanism by which the listed goods would be temporarily under China's state trading regime. This designation will be eliminated in year three, liberalizing trade in steel, acrylic, natural rubber, timber, plywood, and wool. Since January 1, China has allowed nonstate traders to deal in numerous products subject to import licensing, import quotas, and import tendering. Import quota and license requirements were lifted on gasoline, tires, and road tractors. Products no longer subject to import tendering include bulldozers, printing machinery, machine tools, satellite earth stations, and circuit breakers.

Nontariff barriers

Throughout the first two years of China's WTO membership, China's tariff-rate quota (TRQ) system on agricultural products has acted as a nontariff barrier on imports of foreign agricultural goods. Specific barriers included complex licensing procedures, allocation of quota in commercially unviable quantities, lack of transparency in rule setting, and adoption of vague or scientifically suspect phytosanitary requirements.

In response to calls from WTO members to bring its agricultural TRQ administration process into compliance with WTO rules, MOFCOM and NDRC published rules in September 2003 governing the management of TRQs for imported agricultural products. The regulation is an important step in addressing concerns about transparency in China's TRQ allocation process. Yet the rule does not completely resolve problems with transparency, conformity to international standards, and assessment of value-added tax, particularly regarding wheat, corn, and soybean imports.

Standards certification and testing are also, in effect, barriers to imports. China does not recognize any testing or certification that occurs outside of China. Importers must have their products retested in China—a process that can be prohibitively expensive. China also has yet to implement the regulatory framework necessary to allow foreign-invested testing and certification organizations to conduct conformity assessment services for the domestic market. Majority-owned ventures were to be allowed in this area by no later than December 11, 2003.

Finding that WTO spirit

Observers note that China's recent WTO implementation actions have rested with agencies belonging to the central government in Beijing, not at the local level as some have speculated. The main obstacles to implementation are government protectionism and industry protectionism rather than a lack of understanding or resources (see **Box 2**). It is thus up to China's central government to apply pressure internally, if necessary, to make sure its year-three commitments are fully implemented.

Severe acute respiratory syndrome and the change of PRC government leadership may have curtailed China's WTO implementation in year two. To be meaningful, China's implementation in year three must reflect the full terms and spirit of China's WTO entry agreements and ensure that market access is allowed as negotiated. Though China has moved forward on liberalization in some of its services commitments—such as book retail operation and tourist agencies—its tendency to delay regulations or redefine its commitments particularly in areas that open the economy

broadly to foreign participation, such as in trading rights and distribution, do not reassure companies that China will implement its year-three commitments fully.

Box 2: USCBC Membership Survey of WTO Priorities

In July and August 2003, the U.S.-China Business Council (USCBC) conducted a survey of member company views on China's implementation of its World Trade Organization (WTO) commitments in each member's priority areas. Thirty percent of the Council's 208 members responded to the survey. Of those responding, 97 percent said that their business is affected by WTO implementation and 80 percent are significantly affected.

On a scale of 1 (excellent) to 10 (failure) USCBC members gave China an average (unweighted) performance score of 5.15. Most respondents gave China a score within the range of 3 to 7, with an equal number of firms reporting above average and below average progress.

Top issues

Each responding company was asked to select five priority issues from a list of 23 choices. The following 11 issues emerged as the most important concerns for USCBC firms. Issues received a weighted score to reflect their relative importance to respondents. The score was calculated according to the number priority indicated by each firm using the following scale: Priority 1=5 points; Priority 2=4 points; Priority 3=3 points; Priority 4=2 points; Priority 5=1 point.

WTO implementation status

According to the survey, USCBC member companies believed China made most progress in the area of transparency in its second year of WTO membership—though transparency still has not lost its place as a top concern. USCBC companies also reported progress in the development of China's intellectual property rights (IPR) framework and in IPR enforcement, as well as in tariffs and standards; though many firms reported new problems or no progress on standards. Members highlighted trading rights, distribution rights, and nondiscrimination/national treatment as areas in which there has been a pronounced lack of progress and in which new problems have appeared.

USCBC Members' Top WTO Implementation Issues

Issue	Weighted Score
1. Trading rights (ability to import and export)	112
2. Transparency	106
3. Distribution (ability to distribute to wholesalers, retailers, and endusers within China)	97
4. Standards, technical regulations, and conformity assessment	96
5. Intellectual property rights (IPR) enforcement	85
6. Nontariff measures (quotas, licenses, tendering requirements)	79
7. Tariffs	76
8. Specific market-access service commitments	73
9. Nondiscrimination/national treatment	61
10A. Customs and trade administration (classification, valuation, rules of origin)	57
10B. IPR legal framework (patents, trademarks, copyrights)	57

When asked to identify the major obstacles to implementation in their priority areas, a majority of USCBC firms identified government protectionism and industry protectionism. These two barriers were cited as the most important factors impeding progress in almost all areas. Companies also highlighted lack of access to China's rulemaking process as a significant barrier.

Interestingly, respondents did not name low levels of understanding among PRC government officials as a serious barrier to implementation, except in the areas of customs/ trade administration and transparency. Lack of resources was only considered a significant barrier in IPR enforcement.

Background on the survey's top five WTO issues

• Trading rights

Only three members reported that their trading rights problems are now resolved; nine members reported some progress in trading rights. Fifteen members reported new problems or no progress. Respondents overwhelmingly identified government protectionism and industry protectionism as the key obstacles to implementation.

- **Transparency**

Most respondents reported some progress in transparency. Key obstacles to improving transparency included a low level of understanding among PRC government officials, bureaucratic infighting, government protectionism, industry protectionism, and lack of access to China's rulemaking process.

- **Distribution**

Respondents were evenly divided as to whether there has been some or no progress in this sector. No one reported that the issue is resolved. Key obstacles to implementation include government protectionism, industry protectionism, and lack of access to China's rulemaking process.

- **Standards**

Half of the respondents found there was some progress in standards, but the other half found new problems or no progress in this area. Bureaucratic infighting, government protectionism, industry protectionism, and lack of access to China's rulemaking process were all cited as key obstacles.

- **IPR enforcement**

A majority of respondents reported some progress in enforcement, but the issue remains a top concern. Lack of resources, government protectionism, and industry protectionism are the greatest obstacles to enforcement.

—USCBC staff

Co-Chair REINSCH. Thank you very much.
Mr. Trumka?

**STATEMENT OF RICHARD TRUMKA
SECRETARY-TREASURER, AFL-CIO**

Mr. TRUMKA. Thank you, Mr. Chairman, and Members of the Commission.

China formally acceded to the WTO, of course, in 2001, and while U.S. proponents of granting China PNTR claimed that WTO accession would significantly expand U.S. access to the Chinese market, reduce our bilateral trade deficit and improve China's adherence to international norms, the last two years tell a different story.

China's compliance with its WTO obligations is problematic and even deteriorating in a dozen areas. Numerous deadlines have been ignored or evaded. Partial compliance measures appear to be adopted, only to be circumvented by offsetting rules and regulations, and our trade deficit has ballooned from \$83 billion in 2001 to a projected \$125 billion in 2003.

In the face of this record of noncompliance, the Bush Administration has failed to use the tools at its disposal to ensure that China meets its WTO obligations, allowing an imbalanced trade situation to grow progressively worse, burdening American workers and producers.

Meanwhile, China has not hesitated to use WTO dispute settlement mechanisms to challenge the United States on our use of safeguard measures in the steel industry, for example. This situation simply can't be allowed to continue.

At the time of the U.S. Congressional debate over granting PNTR to China, the American labor movement argued that the U.S. Government should have insisted that concrete improvements in workers' rights, human rights and democracy be included as conditions of China's accession to the WTO. Without these essential elements, we argued, China's accession to the WTO would only accelerate the exodus of U.S. jobs while perpetuating and rewarding a system in China where workers are legally prohibited from joining independent unions and where labor laws are routinely violated.

We have long argued that trade agreements also need to contain effective mechanisms to address currency imbalances. China's deliberate undervaluation of its currency has since become a pressing issue. These provisions were not explicitly incorporated into China's accession agreement, however, and now, we believe the ballooning of the bilateral U.S. trade deficit reflects, in part, these crucial mistakes.

In my testimony today, I will quickly address two separate issues: first, China's compliance with its WTO commitments and second, other crucial issues affecting the U.S.-China trade and economic relationship. And then, I'll offer my views on necessary appropriate action needed by the Bush Administration and Congress to rectify these problems.

Two years after China's accession to the WTO, there are significant and in some cases escalating compliance problems in virtually every important area. The USTR's 2003 report to Congress documents the following problem areas among many others: tax policies that favor domestic production; failure to implement obligations regarding retail, trading and distribution rights as they apply to foreign investors or joint enterprises; failure to implement conforming customs regulations; failure to enforce intellectual property rights protections; systematic problems with biotechnology, sanitary and phytosanitary measures; and widespread allegations of illegal export subsidies in electronics, biomedicine, textiles, steel, petrochemical machinery, copper, and corn, among others.

Together, these violations negate many of the promised benefits of China's WTO membership for American workers and companies. In the areas of subsidies, not only has the Chinese government failed to eliminate export subsidies as promised; it has failed to even submit the required notifications that list the existing subsidies, and the USTR's response to China's flouting of these agreed-upon deadlines "to urge China to submit a full and updated notification as soon as possible," to "continue to investigate" and to "raise concerns directly."

Throughout the 67 pages of the USTR report, the words urge, seek, engage, monitor, pursue, clarify and discuss appear repeatedly. Even when China is in egregious violation of its WTO commitments, the most USTR offers is the vague promise that the Administration is fully prepared to enforce U.S. rights through means other than bilateral consultations, including dispute resolution at the WTO.

Well, we believe that the Bush Administration needs to move beyond bilateral consultation and continued dialogue to address the current problems in the U.S. trade and economic relationship. Certainly, the Administration needs to initiate WTO dispute resolution immediately in several areas to ensure that China meets its obligation in a timely and effective way.

Unfortunately, two years since China's accession to the WTO have not borne out the prediction that we would see a rising standard of living and a promotion of human rights in China. Instead, increased trade and investment have coincided with continued harsh violations of workers' rights, rising worker unrest, and a strike hard campaign against dissidents by the Chinese government.

Far from exporting American values to China, American companies have been unable or unwilling to address this abuse, and they've profited from it.

Let me summarize by saying the following: manipulation of its currency, repression of workers' rights, and deliberate measures to block fair access to its domestic market are key parts of the Chinese government's political and economic strategy. These measures are not promoting sound economic development or democracy in China. They're not lifting up poor workers in other developing countries around the world, and they're not benefiting American workers.

Contrary to supporters' claims, China's WTO accession has not even improved China's own compliance with international trade rules. Its accession has helped to expose the fundamental flaws in our international trading system, and the American labor movement will continue to fight for reformed trade laws that create more balanced trade relations between countries, promote sustainable development, and protect workers' rights at home and abroad.

In the coming months, Mr. Chairman, we'll be urging the Administration to take action under section 301 of U.S. trade laws to challenge the Chinese government's deliberate undervaluation of its currency and its systematic and egregious violation of workers' rights. Currency manipulation essentially negates any tariff reduction or subsidy elimination agreed under WTO rules. Violations of workers' rights is defined as an unfair trade practice under Section 301.

Both of these factors continue to combine to tilt the playing field against American workers and producers. At the very least, the Administration must use all enforcement tools at its disposal under WTO and U.S. trade laws to ensure China's compliance with its WTO obligations and its international obligations to respect workers' rights.

Thank you, Mr. Chairman. I apologize for going over.

Co-Chair REINSCH. Thank you, Mr. Trumka.

Mr. Vastine?

**STATEMENT OF ROBERT VASTINE
PRESIDENT, COALITION OF SERVICE INDUSTRIES**

Mr. VASTINE. Thank you very much, Mr. Chairman, and thank you for your consideration about my schedule. And thank you, Mr. Chairman, Bill Reinsch, and Members of the Commission for the opportunity to express the views of the Coalition of Service Industries on China's implementation of its WTO commitments. Many of our member companies have deep and significant presence in China. China's accession to the WTO was a very significant step towards obtaining better market access for U.S. service providers, cross cutting commitments in transparency and to acquired rights, and to binding China to the international rule of law.

U.S. industry must continue to work vigilantly with the Chinese to ensure that they fully implement their reforms and comply with the accession agreements, and we are doing that we will in time succeed.

I would like to note that unlike in goods, the U.S. has had a positive balance in its cross-border services trade with China. In 1992,

U.S. exports to China were \$1.57 billion, with a \$52 million surplus. In 2002, U.S. cross-border services exports to China were \$6 billion, with a positive balance of \$2 billion.

Now, this is peanuts in comparison to goods trade, but unfortunately, we're just at the beginning of our trade relationship in services with China, and we expect that to grow substantially as the result of accession.

Services sales by U.S. affiliates, in China, that is, U.S. foreign investment in China in the services grew exponentially, from \$320 million in 1994 to \$2.6 billion in 2001. I think we're only at the beginning of the growth in our sales to Chinese from U.S. affiliates, which I will tell you is an extremely important element of U.S. services trade. Most of U.S. services trade occurs through foreign investment, not through cross-border trade.

China's WTO obligations in services are comprehensive, and they are ambitious. It took substantial courage for their leadership to conclude the accession process over the resistance of entrenched interests. But, of course, the true value of China's commitments is to be measured by their implementation. Progress has indeed been made, but indeed, much progress remains to be made. Excessive capital requirements, inconsistent application of regulatory transparency and licensing procedures and inconsistent application of new rules among the provinces of China are among the key issues facing our countries.

China's high capitalization requirements in sectors like telecommunications and insurance are incompatible with international norms and best practices and serve as a de facto market access barrier. Transparent and fair regulatory processes are absolutely necessary for trade and investment in services to flourish, because services are typically very highly regulated. China's commitments to transparency are of very high quality. They reflect our own administrative procedures practices and are a model for other WTO accession agreements.

These commitments are a substantial demonstration of the value of trade agreements. To date, China has not consistently applied these procedures. We are very quick to point this out to our Government and to the Chinese, and we expect to make substantial progress.

There was a time when the Chinese would not have considered giving us time to comment on a regulation. Now, they are learning that they must give time for foreign interests and others to comment on a proposed regulation before its implementation.

In licensing, China's accession commitments obligate them to follow important regulatory processes. This was a very significant innovation for any trade agreement. I don't know of a single prior agreement where licensing practices were laid out. In fact, the full benefit of these procedures has not yet been realized, although we expect it to be. The independence of regulators is another important commitment. It provides that regulatory authorities must be separate from and not accountable to the service suppliers they regulate. China has not yet implemented this commitment in several sectors, including telecommunications.

Examples of China's compliance issues by sector include insurance services, banking, securities and asset management, express

delivery, telecommunications, freight forwarding and logistic, digital and software products, intellectual property and pensions. I'll just give two examples out of that long list. In insurance services, China has provided good commitments for sectoral liberalization, which improve market access.

However, the branching commitment has not been entirely fulfilled, and the capitalization requirements still remain indiscriminately high for foreign branches. We hope and expect revised draft regulations on which our industry has been extensively consulted will soon be implemented to correct these problems.

In telecommunications, for example, we are concerned that the independence of China's telecommunications regulator has not been established, and the U.S. telecommunications companies have not yet been licensed to provide value-added services. China's regulator has also reclassified several international value added services as basic services.

Under China's accession commitments, basic services will be allowed for licensing only in December 2004 and will be subject to a \$2 billion RMB capitalization requirement, which is 100 times higher than that for value added services.

So, the U.S. service industry commends and—is very supportive of the USTR, and works very closely with the USTR, Commerce and the Treasury. We engage in a number of sectoral programs with the Chinese that are proving very useful. There is a joint group, industry-government group, on logistics services, the same in electronic commerce services. We have developed a consultative relationship with the Chinese insurance commissioner—Insurance Regulatory Commission to improve their regulations. This is all very valuable. It's incremental. These consultations occur across a wide front and take a lot of time.

Recently, Mr. Chairman, I was in Shanghai. Anybody who goes to China intermittently cannot fail to be impressed each time by the extraordinary vibrancy of that economy. I found myself thanking the stars that China joined the WTO. It does commit them to a body of law and regulation that is enforceable. Heaven knows the time could have come, perhaps, when they felt they didn't have to do it, and certainly, not on such good terms.

It is good that the Chinese belong to the WTO and acknowledge its importance. At the same time we fully recognize that much remains to be done to make China fully compliant.

Thank you.

Co-Chair REINSCH. Thank you very much.

Mr. Carlson?

[The statement follows:]

**Prepared Statement by Robert Vastine
President of the Coalition of Service Industries
To the U.S.-China Economic and Security Commission**

China's Compliance with WTO Commitments in Trade in Services Sectors

Thank you, Mr. Chairman and Members of the Commission, for the opportunity to express the views of the Coalition of Service Industries (CSI) on China's implementation of its WTO commitments. CSI is the leading business association dedicated to reducing barriers to U.S. services exports and mobilizing support for domestic U.S. tax policies, that enhance the global competitiveness of U.S. service providers. Our membership consists of U.S. corporations and associations engaged in global financial services, telecommunications, transportation, express delivery, con-

struction, energy, audio-visual, professional services, travel, maritime, information technology and computer and related services. Many of these companies have significant presence in China and are deeply interested in China's full implementation of its WTO commitments.

China's accession to the WTO was a significant step in obtaining better market access for U.S. service providers and cross-cutting commitments in transparency and acquired rights. Given that China entered the WTO without having implemented its commitments in its domestic law and regulation, U.S. industry and government must continue to work with the Chinese to ensure that China continues its market liberalization reforms.

The U.S. has had a positive balance in its cross-border trade with China. In 1992 U.S. exports to China were \$1.57 billion, with a surplus of \$52 million. In 2002, U.S. cross-border services exports to China were \$6 billion, with a positive balance of \$2 billion. In 2002, China was the 10th largest destination for U.S. cross-border services exports, whereas in 1992 China was only the 21st largest destination. This trade is composed of financial services, telecommunications, transportation, travel and tourism, education (for example, Chinese students in the U.S.), and a large category of "business, professional and technical services." These data do not reflect—or if they do, only slightly—the commercial effect of accession, which of course occurred in December 2001. We would hope that we can shortly measure the impact of accession on U.S.—China services trade.

Services sales by U.S. affiliates in China grew exponentially from \$320 million in 1994 to \$2.6 billion in 2001. By contrast, China's sales through affiliates in the U.S. increased from \$45 billion in 1994 to \$144 in 2001. We can surmise that the volume of U.S. affiliates' sales will continue to grow strongly as China fully implements its WTO services commitments, and our companies expand their reach into the fast growing Chinese economy.

China's WTO obligations in services are comprehensive and ambitious. They demonstrated the Chinese leadership's determination to modernize and integrate economically with the rest of the world. It took substantial political courage for the leadership to conclude the accession process over the resistance of bureaucracies, state enterprises and others vested in the status quo.

But the true value of China's commitments is to be measured by the degree they are implemented. Since accession, China has made great efforts to bring its legislation into compliance with its WTO commitments. This effort is greatly to be commended. Nevertheless, significant sectoral and cross-sectoral implementation issues persist.

Implementation of Cross-Sectoral Commitments

Excessive capital requirements, inconsistent application of regulatory transparency and licensing procedures, and inconsistent application of new rules among the provinces of China are the key issues facing our companies. China's high capitalization requirements in sectors like telecommunications and insurance are incompatible with international norms and best practices, and serve as a de-facto market access barrier.

Transparent and fair regulatory processes are absolutely necessary for trade and investment in services to flourish. China's commitments here are of very high quality. They reflect our own administrative procedures, and are a model for other WTO accession agreements. These commitments are a substantial demonstration of the value of trade agreements.

China's commitments to transparency in making and implementing laws, regulations and other measures, and in reviewing regulatory decisions, are based on the provisions of Articles III and VI of the General Agreement of Trade in Services (GATS) relating to transparency, and are intended to amplify these underlying commitments. They are of course meant to provide reasonable assurance that laws and regulations promulgated to implement China's liberalization commitments will be accomplished in a transparent way. They apply to regulatory processes related to international trade. We expect there may also be a "spillover" effect of these trade-related transparency provisions into the wider regulatory environment.

The Accession Protocol (paragraph 2(C)) contains the most important undertakings; these are supplemented by relevant sections of the Working Party Report (paragraphs 306–9, and 324–36).

Together, they cover procedures by which laws, regulations and other measures are implemented, the creation of a system of administrative and judicial review, procedures for licensing, and the establishment of independent regulatory authorities.

Procedures for Implementing Laws, Regulations and Other Measures

In Protocol paragraph 2(C) China commits that only those laws and regulations and other measures that are published shall be enforced, and further commits that all laws and regulations shall be publicly available before they are enforced, except in emergencies, when they will be available upon implementation. An official journal must be designated for their publication.¹ China commits to allow “reasonable periods” for comment before implementation. There is no requirement that Chinese regulatory authorities respond to comments of interested parties, or explain the reason for a decision. And to date they have implemented the “reasonable period” requirement very loosely indeed.

China also commits to establish enquiry points where any interested party can obtain all information on all laws and regulations. Requests for information should be answered in 30 days. In exceptional cases replies may be delayed up to 45 days, but only with a statement of reasons in writing to the inquiring party. Replies to the information requests of *WTO Members* must represent the “authoritative view” of the government of China. Other inquiring parties (individuals and enterprises) shall be given “accurate and reliable” information.

Judicial Review

China must establish independent, disinterested tribunals and procedures for prompt review of all administrative actions relating to implementation. Appeal of an administrative tribunal decision can be made to a judicial body. Notice of decisions, and a written statement of reasons for a decision, will be given to the appellant.

Licensing

The Working Party Report commits China to an important regulatory process in licensing decisions. This was a significant innovation in an accession agreement. These rules go beyond transparency to stipulate a licensing procedure that should be much simpler and faster than applicants have previously experienced. In fact the full benefit of these procedures has not been realized.

Procedures for reviewing license applications must be published before becoming effective, and they must provide “reasonable time frames” for review and decision. Applicants may request a license without an invitation by the government to do so. Applicants must be notified whether an application is complete, and what additional information is necessary for its completion. Decisions will be taken promptly, and if an application is denied, the applicant will be informed in writing without delay the reasons for the decision. If denied, the applicant may resubmit the application.

If approved, the applicant will be informed in writing. *The approval permits the applicant to start commercial operations* after registration with the State Administration for Industry and Commerce (SAIC); the SAIC must complete the registration process in two months.

Independent Regulators

The independence of regulators is addressed in paragraph 309 of the Working Party Report. It provides that, for services that China has scheduled in the GATS, regulatory authorities must be separate from and not accountable to the service suppliers they regulate. Courier and rail transport services were exempted from this requirement, but the Chinese government must regulate these two sectors in a way that does not violate its accession commitments.

Compliance with Transparency Commitments

Despite these extensive transparency commitments, U.S. companies have been denied the right to comment, or are unable to comment due to very short periods allowed for their input even on important sectoral laws and regulations. We are also concerned that China’s regulations may not be sufficiently specific in stating qualifying criteria for services providers, which gives regulators broad discretion in applying those requirements. Chinese laws, regulations, and administrative practices frequently change without warning, and may not be applied uniformly, especially on the local level. For example, there is differential treatment of imports among customs districts.

Sector-Specific Implementation Issues

Examples of China’s compliance issues in market access and national treatment in services trade since accession include the following:

¹ Paragraph 334 of the Working Party Report commits China to provide translations of laws and regulations to the maximum extent possible before implementation (but in no case later than 90 days after implementation).

- In insurance services, China has provided meaningful commitments for sectoral liberalization, which improve market access, provide for national treatment and allow internal branching. However, the branching commitment has not been entirely fulfilled, and the capitalization requirement still remains discriminately high for foreign branches. We hope that revised draft regulations will be soon implemented to correct these disparities. Our companies would like to confirm that branches and other insurance company operations may continue to operate under the conditions and approvals that existed prior to the issuance of new sectoral rules. We also believe that foreign companies should be provided national treatment in obtaining provincial level licenses. The U.S. insurance industry hopes that the ongoing dialogue between U.S. trade officials and CIRC, the Chinese insurance regulator, will resolve these long standing market access issues.
- In banking, we are concerned about the proposal of the People's Bank of China to limit RMB refinancing through bilateral inter-bank loan agreements to 40 percent of total RMB liabilities. We understand that the PBOC has abandoned this proposal, however we ask to confirm it. Additionally, China should eliminate its discriminatory branch capital requirements on foreign banks, which must pay up to five times the amount paid by Chinese banks.
- In securities and asset management, U.S. companies would like to be able to establish securities companies through vehicles of their choice. The U.S. industry is also concerned that the new securities regulations have imposed several market access restrictions including deposit requirement on qualified institutional investors.
- In express delivery, the U.S. industry has significant reservations about the proposed extension of China Post's monopoly to deliveries of domestic letters under 500 grams, according to the draft postal regulations. These draft regulations also create a new unspecified charge on express industry revenues to help support China Post's universal service, as well as a new, unworkable licensing regime which gives new powers of supervision, inspection, and punishment to the postal regulator. Therefore, the industry urges that China Post's roles as regulator and operator be separated.
- In telecommunications, we are concerned that the independence of China's telecommunications regulator has not been realized and that U.S. telecommunications companies have not yet been licensed to provide value added services. China's regulator has also reclassified several international value-added services as basic services. Under China's accession commitments, basic services will be allowed for licensing only in December 2004, and will be subject to a 2 billion RMB capitalization requirement, which is 100 times higher than for value added services.
- In freight forwarding and logistics, foreign companies confront operational restrictions on services between separate licensed areas. Furthermore, international freight forwarding companies should be extended national treatment and be entitled to obtain a national operating license.
- In digital and software products, customs valuation should be based on the value of the underlying carrier medium. Chinese authorities should also provide for foreign companies' full participation in standard-setting for the Enhanced Versatile Disc standard. They should also permit foreign companies' access to government procurement of software products. China should join the WTO Government Procurement Agreement and facilitate establishment of a non-discriminatory and transparent government procurement regime.
- In IPR we believe that China's implementation of its commitments should provide for lowering the high threshold (currently RMB50,000 or about US\$6,000) used to establish prosecutable criminal offenses, extending criminal penalties to all infringements occurring on a commercial scale as required by TRIPS, and ensuring adequate criminal liability for criminal offenses.

Also, China committed to liberalize its pension market within three years of joining the WTO. To date, no regulations or laws have been released in anticipation of the opening of this important market sector. CIRC or other relevant authorities should begin a public comment process well in advance of the approaching phase-in deadline to gain the broadest level of comment and support for this fundamental undertaking.

The U.S. services industry would greatly benefit from better market access as a result of full implementation of China's WTO accession commitments, and we hope that market access conditions will improve as China continues phasing in its accession obligations. Accession to the WTO binds China to significant structural reforms, which will reshape its services market. Foreign services providers expect that nec-

essary regulatory amendments will be made to the full extent provided by the Protocol of Accession and the Working Party Report. In this way, China can demonstrate its commitment to its WTO obligations.

The U.S. services industry commends efforts of the USTR, the Treasury and Commerce Departments to monitor China's compliance. We also appreciate USTR's efforts to raise important sectoral issues at the WTO Trade Review Mechanism meetings, and in bilateral negotiations and consultations. All these forums are useful in obtaining China's compliance.

Despite the disappointing outcome of the WTO Ministerial at Cancun, the U.S. services industry still considers the WTO the principal forum to secure further meaningful liberalization of trade in goods and services on a large scale. We expect that China will be an active participant in services negotiations in the Doha Round. It is worth noting that China has submitted its offer, and we expect that in the context of these negotiations we can achieve greater progress in China's liberalization.

Thank you.

**STATEMENT OF ROBERT CARLSON
CHAIRMAN OF THE LEGISLATIVE AND TRADE COMMITTEE
NATIONAL FARMERS UNION**

Mr. CARLSON. Thank you, Mr. Chairman, and Members of the Commission for the opportunity to appear before you here today on behalf of the National Farmers Union to discuss this important issue of agricultural trade between our two countries, the U.S. and China. I want to say a particular word of appreciation to Commissioner Mulloy for his extension of greetings from Senator Dorgan.

The National Farmers Union, to briefly describe it, is a general farm organization, meaning that our members produce many, many commodities and that we represent our farmers and ranchers and vegetable and fruit producers and peanut producers, all of that, all across the agricultural spectrum: dairy, beef, all of it. So we are not just a commodity group. We are a general farm organization, and our members are concerned about trade in agricultural products.

I want to be up front, and I'm going to summarize my written testimony, which you have. The National Farmers Union opposed the legislation granting permanent normal trade relations to China that paved the way for its accession to the WTO. This action was adopted by our membership after some debate, and it was based on the producer belief that it was going to be very important for there to be periodic review of China's compliance with trade rules once they had MFN status. So, we believe what you're doing is an important part of ensuring that they are complying with those rules.

The fact that we opposed PNTR does not suggest that NFU supports a protectionist agricultural trade policy for the U.S. On the contrary, we fully recognize that as is the case with billions of other people across the globe, China's growing population must be adequately fed, and fair agricultural trade is necessary if progress is to be made in ensuring world economic, social and political stability.

In addition we fully recognize that the U.S has the most open and accessible market for both agricultural and manufactured products, including, with few exceptions, those from nations that are not members of the WTO.

Let me address the issues that are most important, now. Compliance: as you are aware, China committed to a significant reduction of tariffs on a wide range of agricultural products and the elimination of quotas for significant bulk commodities, which would be

replaced with tariff rate quotas. China also agreed to a cap on domestic supports that are deemed trade distorting at percentage levels below those applied to developing nations as well as the elimination of all agricultural export subsidies.

In the area of sanitary and phytosanitary measures, China became obligated to compliance with the WTO SPS agreement, which requires a legitimate scientific basis for the imposition of import restrictions, based on food, health, safety, pest and disease and risks. In addition, China agreed to allow a share of the specified TRQs for wheat, corn, vegetable oils and cotton to be imported by non-state trading enterprises.

China's compliance with its PNTR and WTO agricultural commitments can best be described as mixed. Progress appears to be occurring, albeit somewhat behind schedule, and the shift to TRQs from China's high tariff levels and restrictive quotas; however, market access for several bulk commodities that as late as last year were impeded by burdensome licensing, inspection and quarantine procedures, lack of transparency in the establishment of subquotas for the processing and re-export trade still has not resulted in the TRQ fill rates that were envisioned.

New regulations to correct these problems were to be implemented January 1, 2004, and will require additional monitoring. Market access for U.S. ag products has also been limited by China's use of nontariff measures and inconsistent application of what appears to be an evolving food safety program. For example, in the case of wheat, a commodity of special interest to me and many of my members in North Dakota, China relaxed its zero tolerance for TCK smut; however, it also implemented a new maximum residue level for selenium that is below international standards and imposed an MRL for vomitoxin, even though no international standard exists. There are other examples of similar action with regard to other products.

U.S. officials have engaged their Chinese counterparts in discussions over these issues at various levels within the Chinese government and at times seem to make some progress. However, it appears that China is engaged in an approach to compliance that allows them to systematically influence agricultural trade to their own purpose and advantage by moving toward compliance in one area while establishing new, unfair trade practices in another, many of which are not technical violations of the existing agreements or even the subject of current multilateral trade negotiations.

As we embark upon the third year of China's membership in the WTO and its commitment to abide by those trade rules, many sectors of U.S. agriculture are beginning to question whether any real gains are in fact accruing to U.S. producers. If the cause of relatively poor U.S. agricultural trade performance, with the noted exception of the oil seed industry, is due to China's failure to comply with its commitments, then the U.S. should utilize its rights under the WTO as well as our domestic trade remedy laws to reestablish the leverage necessary to gain compliance.

With regard to China's global commitment to agricultural trade, compliance with trade commitments is an important issue; however, I strongly suspect that factors, including China's own goals

for maintenance of its centralized government, achieving its domestic economic growth and providing food security have more to do with our agriculture trade performance with that nation than with China's level of success in meeting those commitments.

In other words, China may well act in its own self-interest. We should not be naive in believing that nations will seek to advance and comply with a global free trade agenda that may result in their sacrificing and subverting their own national interests and sovereignty. The apparent good news for trade advocates, notwithstanding concerns with China's compliance with its trade commitments, is that U.S. agriculture exports to China have grown by approximately \$2 billion in the three years, and our ag trade surplus with China has expanded in the same period.

On the import side, China has also increased its agricultural exports to the U.S. by over 40 percent, or nearly \$375 million during the 2000–2003 period. All of that increase was in agricultural commodities and products that directly compete with U.S. production in our domestic market. I have an example of orange juice and so forth, but just very briefly in conclusion, we need to recognize three points: our global agricultural competitors also view China as representing a vast new market for their products. Number two, China is a very sophisticated trader that has and is likely to continue to use its market power to influence commodity price and trade volumes. And three, as a major producer of many commodities, China is not only capable of food self-sufficiency but represents a direct threat to U.S. agriculture in both our domestic and third country markets.

Thank you very much, Mr. Chairman.
[The statement follows:]

**Prepared Statement of Mr. Robert Carlson
President of the North Dakota Farmers Union**

Introduction

Mr. Chairman, Members of the U.S. China Economic Security Review Commission, I am Robert Carlson, a farmer from North Dakota and president of the North Dakota Farmers Union. I also serve as chairman of the Legislative and Trade Committee of the National Farmers Union (NFU) on whose behalf I am pleased to appear before you today to discuss our views concerning agricultural trade issues between the United States and China.

The National Farmers Union was established in 1902 as a general farm organization that provides, among other services, public policy representation and advocacy on behalf of our members across the United States on a variety of agricultural issues including trade. Unlike most farm organizations that represent the narrow and parochial interests of a single commodity, our membership is comprised of family farmers and ranchers who collectively produce a broad spectrum of U.S. agricultural commodities and products.

Let me be upfront. The NFU opposed the legislation granting Permanent Normal Trade Relations (PNTR) to China that paved the way for its accession to membership in the World Trade Organization (WTO) because basic concerns about this proposal and trade agreements in general were not being addressed. This action, adopted by our membership, was based on producer belief that the periodic review of China's trade and policy actions required prior to extending Most Favored Nation (MFN) status was critical to the establishment of fair agricultural trade with that country. We viewed this leverage as particularly important in the case of China, given its substantial influence in the trade of agricultural commodities as a major producer, importer and exporter.

We continue to believe that many important issues, beyond the so-called three pillars of market access, domestic supports and export subsidies, have such a profound impact of agricultural trade that they must be considered in all trade negotiations and are of particular importance in the case of China. These issues include labor

standards, environmental regulations, exchange rate adjustments and the level of policy transparency provided by our trading partners. Our concern was that China would not only fail to meet its commitments but was also engaged in national policies and practices that provided it an unfair competitive agricultural trade advantage which outweighed any potential benefits that might accrue from its membership in the WTO and agreement to abide by the global trading rules.

Our members also viewed the rather dismal record of effectiveness and timeliness of the global trade dispute resolution process and the prospect that compliance monitoring would be under-funded and unlikely to ensure China fulfilled its obligations as reasons to oppose PNTR. In addition, we did not accept the rhetoric of those who so fervently supported China PNTR believing it would stimulate a new level of broadly distributed U.S. agricultural export benefits that would create prosperity for America's farmers and ranchers.

This does not suggest that NFU supports a protectionist agricultural trade policy for the U.S. or is opposed to trading agricultural products with China or any other nation. On the contrary, we fully recognize that, as is the case with billions of other people across the globe, China's growing population must be adequately fed and fair agricultural trade is necessary if progress is to be made in ensuring world economic, social and political stability. In addition, we fully recognized that the U.S. has the most open and accessible market for both agricultural and manufactured products including, with few exceptions, those from nations that are not members of the WTO.

However, in our rush to make China a WTO member and bring it within the rules of the global trading system we continue to face numerous challenges both in our bi-lateral trade relationship with China and across the spectrum of agricultural trade issues worldwide. Some of these challenges concern the interpretation and level of compliance with the rules and commitments on both market access and export competition contained in the PNTR and WTO ascension agreements, some represent a level of naiveté about other nation's commitments to the spirit of fair trade and some challenges are the result of creating trade expectations that are unlikely to be fulfilled.

Compliance

As the Commission is aware, China committed to a significant reduction in tariffs on a wide range of agricultural products and the elimination of quotas for specific bulk commodities which would be replaced with tariff rate quotas. China also agreed to a cap on domestic supports that are deemed trade and production distorting at percentage levels below those applied to developing nations as well as the elimination of all agricultural export subsidies. In the area of sanitary and phytosanitary measures, China became obligated to compliance with the WTO SPS agreement which requires a legitimate scientific basis for the imposition of import restrictions based on food health, safety and pest and disease risks that does not discriminate between WTO members. In addition, China agreed to allow a share of the specified TRQs for wheat, corn, vegetable oils and cotton to be imported by non-state trading enterprises.

China's compliance with its PNTR and WTO agricultural commitments can, at best be described as mixed. Progress appears to be occurring, albeit somewhat behind schedule, in the shift to TRQs from China's high tariff levels and restrictive quotas on many agricultural products. However, market access for several bulk commodities, that as late as last year were impeded by burdensome licensing, inspection and quarantine procedures, lack of transparency and the establishment of sub-quotas for the processing and re-export trade, still has not resulted in the TRQ fill rates that were envisioned. New regulations to correct these problems were to be implemented in January 1, 2004 and will require careful monitoring in the future to prevent any "backsliding".

Market access for U.S. agricultural commodities has also been limited by China's use of non-tariff measures and inconsistent applications of what appears to be an evolving food safety program. For example, in the case of wheat, a commodity of special interest to me and many of my members in North Dakota, China relaxed its zero tolerance for TCK smut, however, it also implemented a new maximum residue level (MRL) for selenium that is below international standards and imposed a MRL for vomitoxin even though no international standard exists. For numerous pathogens associated with poultry and meat products, China has established a zero tolerance which is unrealistic and unachievable. In addition, exporters have expressed concerns that China's inspection and quarantine regulations are utilized to control trade flows and influence market prices rather than provide legitimate food safety protections.

In terms of China's elimination export subsidies and its application of disciplines on domestic support programs, it is unclear to what extent compliance is being achieved or the level of discipline it will undertake in the future. Direct export subsidies and producer income support payments can be measured by reviewing the levels of government outlays for specific functions assuming that information is made available. However, it is possible for nations, including China, to establish programs, fail to adequately enforce domestic laws and/or utilize monetary and fiscal policies to provide indirect production and/or trade distorting subsidies which violate the spirit of trade commitments but may not be easily discernable or even illegal under the operative trade rules.

U.S. officials have engaged their Chinese counterparts in discussions over these issues at various levels within the Chinese government and at times seem to make some progress in achieving compliance with the agreed upon commitments. However, it appears that China is engaged in an approach to compliance that allows them to systematically influence agricultural trade to their own purposes and advantage by moving toward compliance in one area while establishing new, unfair trade practices in another, many of which are not technical violations of the existing agreements or even the subject of current multi-lateral trade negotiations.

As we embark upon the third year of China's membership in the WTO and its commitment to abide by those trade rules along with the side agreements it negotiated with other nations to expedite its ascension, many sectors of U.S. production agriculture are beginning to question whether any real gains are in fact accruing to U.S. producers from these actions. If the cause of relatively poor U.S. agricultural trade performance, with the noted exception of the oilseed industry, in terms of exports to China and our competition with it in our domestic as well as third-country markets is due to China's failure to comply with its commitments, then the U.S. should utilize its rights under the WTO as well as our domestic trade remedy laws to re-establish the leverage necessary to gain compliance.

Global Commitment To Agricultural Trade

Compliance with trade commitments is an important issue. However, I strongly suspect that factors including China's own goals for maintenance of its centralized government, achieving economic growth and providing food security and self-sufficiency have more to do with our agricultural trade performance with that nation than China's level of success in meeting those commitments.

This situation is really no different than the global agricultural trade challenges we face with nearly every other nation. Trade negotiators and public policy officials must recognize that even as global trade expands and world markets become more integrated and interdependent, all nations will continue to view agriculture differently than other economic sectors because it is in fact different. Food security and safety, the economic and market realities of production agriculture, its importance in natural resource management and the maintenance of a nation's social fabric and infrastructure all separate farming and ranching from other economic pursuits across much of the world.

We should not be naïve in believing nations will seek to advance and comply with a global free trade agenda that may result in their sacrificing and subverting their own national interests and sovereignty. Regardless of their rhetoric, if the most stable and developed nations of the world, including the United States, will not agree to such an outcome, why should we expect developing countries to voluntarily do so whether their economies are centrally planned or based on relatively free market fundamentals.

Trade Expectations

The apparent good news for trade advocates, notwithstanding concerns over China's compliance with its trade commitments, is that U.S. agricultural exports to China have grown from \$1.47 billion in 2000 to \$3.47 billion in 2003, achieving the level of export gains projected by USDA. Our agriculture trade surplus with China also expanded from \$660 million to about \$2.3 billion during the same period. However, the breadth and sustainability of these trade gains across the many sectors of U.S. agriculture should be of concern to farmers who were led to believe China would represent some type of trade miracle. Of the increased agricultural exports from 2000 to 2003, oilseeds, cotton and animal hides represented about 85 percent or \$1.7 billion of the export growth and cotton witnessed over a six-fold increase in export value in just this past year.

On the import side, China also increased its agricultural exports to the U.S. by over 40 percent or nearly \$375 million during the 2000 to 2003 period. All of the increase was in agricultural commodities and products that directly compete with U.S. production in our domestic market. The import categories representing signifi-

cant gains included animals and animal products, vegetables, fruits and grains and feeds. All products where we believed our export levels would be enhanced by normalizing trade with China. In fact, we have a net trade deficit of \$100 million in vegetable trade, \$110 million in fruit products, \$20 million in grains and feeds and even a \$3 million deficit in poultry and poultry products.

China's exports of apple juice concentrate to the U.S. have not only damaged U.S. apple growers economically but strongly indicates that trade in a commodity where we believed we had a true comparative advantage, if only global market access was improved, may not yield the benefits previously assumed. In the case of the food and feed grain markets, sectors where we expected substantial export growth, China has evolved as our major competitor in global corn trade. Before it aggressively engaged in the corn export market in recent years, it had accumulated over 45 percent of the worlds ending stocks of corn. It did so, not from imports, but from its domestic production capacity. China currently holds over one-third of the world's wheat stocks and about 60 percent of global rice inventories. For grains, China's import demand will be determined more by short-term production shortfalls, quality and location factors than any consistent import requirements to meet its domestic needs.

Conclusion

The U.S. has focused the vast majority of its attention on agricultural exports to China under an assumption that China, with 1.3 billion people and a growing economy it represents an almost unlimited market for U.S. agricultural products. We must recognize three important points: 1) Our global agricultural competitors also view China as representing a vast new market for their products. 2) China is a very sophisticated trader that has, and is likely to continue to utilize its market power to influence commodity prices and trade volumes to its own benefit rather than to create greater trade stability and predictability. 3) As a major producer of many commodities, China is not only capable of food self-sufficiency, but represents a direct threat to U.S. agriculture in both our domestic and third country markets.

Panel III—Discussion, Questions and Answers

Co-Chair REINSCH. Thank you very much Mr. Carlson.

And now to, as I said earlier, in order to accommodate Mr. Vastine's schedule, I'm going to first ask Commissioners if they have questions specifically for Mr. Vastine. Otherwise, we'll go on to everyone.

Commissioner Wessel?

Commissioner WESSEL. And you may want to supply the information in the longer term, I understand that.

Mr. VASTINE. One of those kinds of questions!

Commissioner WESSEL. One of those kinds of questions, yes. As you well know, increasing concern has been levied over the last months about the issue of offshoring, the issue of services. How many of your members—you talked about the dramatic growth in the investments, FDI, of the service companies in China. How many of them have used that as a platform to also serve the U.S. market?

Mr. VASTINE. To sell services from foreign affiliates?

Commissioner WESSEL. If I remember, your organization also has IT services and a number of other things. We've seen back room services; we've seen—

Mr. VASTINE. I don't think—I haven't surveyed, but our members normally go to China to develop the Chinese market. They—I don't know of a case, I don't have a single case right off the top where they do it in order to service this market, not a single case.

Commissioner WESSEL. So, if we've gone through a number of case studies here of companies that are servicing the U.S. market; if we send some of that information, we can have you talk to those members—

Mr. VASTINE. Sure, I'd be glad to.

Commissioner WESSEL.—of your organization.

Mr. VASTINE. It's an interesting question. Never occurred to me.

Commissioner WESSEL. Okay; thank you.

Co-Chair REINSCH. Commissioner Mulloy, did you have a question for—

Co-Chair MULLOY. No.

Co-Chair REINSCH. Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

It's just a follow-up on that. We'd also be interested in knowing about the companies in these various service sectors that have gone to China to penetrate the Chinese market. And the question is whether or not in going to China to service the Chinese market, the Chinese extort—maybe that's the wrong word—use in order to get in, there must be a provision of R&D technology centers, as in the case of telecommunications firms. We know, for example, that is the case in the case of some telecommunications firms.

We believe that is WTO-illegal. We don't know whether that is continuing to happen. But we are interested in whether or not companies feel that they must provide advanced R&D and place it in the Chinese market or provide other kinds of things that would allow the Chinese to develop their own industries—

Mr. VASTINE. Right.

Vice Chairman D'AMATO.—and of course, then finally supplant our businesses that are there, then, temporarily.

So we're interested in the kind of prices that have to be paid, let's say, to access the market.

Mr. VASTINE. Very good question.

Vice Chairman D'AMATO. And we don't have a handle on that, but we'd like to know more about that.

Mr. VASTINE. Well, that's very interesting, actually, and since accession or under the accession commitments and in the context of the WTO, members of the WTO are not permitted to extract QRs or economic needs tests, commitment from investors who wish to do business in China.

Vice Chairman D'AMATO. Yes.

Mr. VASTINE. So, it's not permitted.

Now, before accession, there were lots of examples of companies seeking to do business with China to establish who unfortunately, and this is the enormous disadvantage of a process that's not administered transparently and according to the rule of law, according to correct procedures, who were asked or who volunteered to, while dancing attendance on the bureaucracies and the various regional authorities, to offer an education program here, a gift of an important cultural object there, this or that.

Since accession, this process is already changed—not as completely as we would have liked or as we expect it soon to be—but I'm not aware of the same level of need to, because you're being put in a queue, a long queue for a license, to sort of take side measures to enhance your standing with those who are making the decisions, including the top leadership.

Co-Chair REINSCH. Okay; thank you.

Commissioner Wortzel?

Commissioner WORTZEL. Mr. Carlson—

Co-Chair REINSCH. Vastine only this time.

Commissioner WORTZEL. I don't have any for him.

Co-Chair REINSCH. Oh, excellent. Well, if there's no more questions for Mr. Vastine, then, we will release you.

Mr. VASTINE. Thank you.

Co-Chair REINSCH. And thank you very much.

Mr. VASTINE. Thanks for inviting me.

Co-Chair REINSCH. The rest of the panel is still here, and we'll go back to the beginning and start with Commissioner Becker.

Commissioner BECKER. Thank you very much, Mr. Chairman.

The questions I have is for all the panelists—but we won't hold Mr. Vastine on that.

I have two questions. The first one concerns competing. We hear an awful lot of talk about the American workers have to be able to compete with the Chinese and other workers throughout the world. I don't know if I know what that means. I would like to get your an opinion on that.

We talk about a level playing field. We talk about eliminating tariffs and market barriers. We're talking about having access, transparency, the exchange rate. I guess my question comes down to this: if those things were done, would we be able to compete with the Chinese worker? And I want to tell you the hard lesson that I had driven home to me back when the Asian economic crisis took place and we were being flooded with steel in the United States.

Hank Barnett was the CEO of Bethlehem Steel at the time. We were talking about our members, and he said "George, let me be frank with you. You could work for nothing, zero, and we couldn't compete."

So I'd really like to know what we're talking about.

Mr. TRUMKA. Well, first of all, I don't know that it's really about competing, because many factories in the United States that get closed are very, very profitable factories: refrigerator factories, the Magnaquench factory, which was a Steelworkers facility that made the only magnets for smart bombs. The Chinese came in, bought it, ran it for a little while, got the technology, closed it down and moved to China with it. It wasn't about competing. They were competing with everybody in the world.

If you removed a lot of the impediments, the exchange rates and all of the subsidies and the unfair trading practices, the unfair advantages that they get, I think the American worker can compete with anybody in the world, because of our innovativeness, because of our productivity and because of everything.

But it's not about competing, George. It's about increasing profits. Can we compete in the marketplace and earn money, good profits for our companies? Absolutely. The question is, is it enough to satisfy their thirst? And it appears that no matter how well we do, it isn't enough to satisfy their thirst.

That's why the rules have to be leveled, and what we need is a chief executive in the White House who starts looking at people and starts to say, we want you to produce here. They get rewarded by our tax code for going offshore. They get rewarded by the trade practices for going offshore, and now, they're starting to take even professional jobs and service jobs offshore.

The interesting question I think you should ask Mr. Vastine was are there any markets that they're supplying from China that they

used to supply from the United States? That's the real issue, because the answer is yes, they are.

So I think that given a fair chance, we can compete with anybody in the world. But this isn't about competition. This is about different levels of profits.

Commissioner BECKER. Fair enough. Does anybody want to add to that?

Mr. KAPP. I guess I would, Mr. Becker. I wish there was a way of being off the record in a meeting like this, to discuss this point frankly, but of course, there isn't. But I would welcome a chance to talk privately about this with you sometime, because I think you've put your finger on some extremely basic issues. At the end of my piece in *The China Business Review* two or three issues ago on the controversy over the Chinese currency, or RMB, I basically said I think the RMB issue is a distraction; I did not say a cruel hoax on American workers.

But I did say I think it's a distraction; I did not say "a cruel hoax on American worker." But I did say I think it's a distraction, because there's a much bigger reality that you have touched on than the RMB. The reality is that China—; India—; who knows, perhaps Brazil 15 or 20 years from now—are large continental nations with economies expanding in every sector. These are not single-product economies that live or die on one crop or one industries. These are countries that have big, geographically varied landmasses. Their economies encompass just about the full range of human economic activities.

And they are now beginning to be able—the Chinese, amazingly after 150 years of not getting it right have begun to get it right—to apply technology, modern managerial skills and a disciplined (many would say highly motivated) but still low-paid work force to perform tasks which in the past could only be performed by the high income market economies of the United States, Europe and Japan.

And I agree, that is a huge, historic conundrum. I don't have an answer to the conundrum, but if Commissioner Becker, you're saying what I think you're saying, you are indeed pointing to a looming structural change in the world economy that the United States and other advanced, high-income economies must face.

Now, in other venues, I might propose with humor that Congress should pass a law saying that "Any country that has a per capita income of less than, say, \$10,000 a year is an unfair trader." Because when you really, really, get down to it even if you leave aside these endless clichés about "inexhaustible supply of cheap labor." Go to any online news search and search for "China and inexhaustible supply of cheap labor" and see, from the large number of items you turn up, what I'm talking about, that is where the important concern you've raised could lead us. A part of me wishes that Americans would be more frank with themselves and others, and come face to face with the questions of whether the poverty of other nations with whom we trade shall be deemed, in our political system, an intolerable economic threat to the United States. Put that starkly, I suspect most participants in this debate would rush to deny that that was their intent. But I do think that that really is one of the ultimate questions that underlies much of the trade de-

bate in the United States today, as poor countries begin to compete in wealthy countries' accustomed areas of economic power.

Commissioner WESSEL. Mr. Kapp, you make an interesting point, and clearly, we have much broader issues at stake here. And it's not just about China; it's about India, Brazil and the up and coming countries as well.

But the frustrating part, I guess, which I would like you to respond to and the others on the panel is when we have these artificial impediments, artificial barriers to our trade, our exports to those countries, the frustration level of our workers, our farmers, our businesspeople rises to a fever pitch, and they see some of the investments that are taking place in China as being forced upon them at the loss of their own jobs because of the delay in time it's going to take China to fully accommodate their WTO accession commitments, et cetera.

What do we do in the interim? We've had, you know, three Section 421 cases, two of which the ITC said that the plaintiff was correct, and the Administration said it's not necessarily in the national interest to pursue; a safeguard measure that was put in the accession agreement. We have countless people looking at plants closing, you know, frustrated about wage levels, worker rights and everything else, but on top of that a recognition that they just can't, if they work hard, play by the rules, they can't sell their products in China.

How do we accelerate this process? How do we get China to live up to its commitments without, as I think it was Mr. Trumka using words like engage, urge, et cetera; you know, the people are a little sick and tired of waiting for Godot.

Mr. KAPP. Mr. Wessel, you're asking a question about a topic, which is, as we all know, intensely political. And every one of those individuals who has seen his job disappear because the plant is closing, and the production is moving to another country has the right to vote and attempt to use the political system to redress what he's been subjected to.

But at the end of the day, I guess I disagree with Mr. Trumka. In fact, it is in the urging and the consulting and the engaging that we're going to get the most bang for the buck, even if it does not satisfy people by the 3rd of November or by the day their unemployment benefits run out.

I don't mean to sound as though I am unaware of the anxieties and the fears and the sufferings that are involved here for American workers, but in fact it is in the "engaging" and the "urging" and the meetings and the commissions and the ministerials and the Zoellick trips to China and the Wu Yi trips to the United States and so forth that we're going to make the most progress on this.

I think it is a mistake to assume that had we—it's too late anyway, of course—but had we not passed PNTR, or had China not gone into the WTO, this situation would have been a lot better. We can argue retroactively about whether the hammer of the bilaterals conflicts that we came to the brink of over and over again in the old days would have been more effective.

But my own view is that the answer to that is no. So you've asked a question which is an intensely political one, and I don't

really have a perfect answer to it. We have to increase exports, obviously; they're growing; they need to grow more. We have to hold the Chinese to their commitments. But there are many ways to do that. I would be the first to say if there's a clear, strong case, bring a WTO case. I've never seen any problem with that.

We used to feel or be told that, in fact, bringing WTO cases was going to help reform reform-minded officials inside China to make the system comport more fully with WTO requirements. I don't have a problem with that if there's a strong case.

But your question is, what do you say to someone whose unemployment is running out this week and who's listening to candidates claiming that they've got the answer? As far as how we deal with China, I'm afraid I don't have a better answer than the "consulting" and the "urging" and the "engaging" and the working through these problems. I should add, however, that this problem is not solely a matter of how we deal with China; it raises very significant, but largely unaddressed, questions as to how we as a nation should be addressing domestically the challenges arising from major structural shifts in the world economy.

Commissioner WESSEL. Rich, did you have a comment?

Mr. TRUMKA. Yes, I really do have a comment on that, because I think the American public has had about all the urging and the engaging and monitoring that they can stand.

This is like playing a baseball game. One side gets three outs, and the other side gets 12 outs per inning. It wouldn't be very many innings before the side that got three outs said wait a second, either stop the game or change the rules: we all need to play by the same rules. We're not doing that.

And unfortunately, the Chinese people are the most patient in the world, and unless we take stronger enforcement mechanism, 25 years from now, we'll still be engaging, we'll still be urging, and we'll still be seeking. Only by that time, there won't be much to urge, seek or cajole for, because all the industries that we have will be decimated. Our economy will be decimated.

So, I think we get real disingenuous, and the country gets disserved because we can't have a real debate about this issue without one side screaming about us, about calling us protectionists rather than trying to talk about the rules.

All we're about is trying to make sure that the rules are fair. You talked about an inexhaustible supply of cheap labor. It will always be cheap labor, because workers in China don't even have the right to join a union and better their lot, and the mechanism we have right now that we're supposed to rely on is the companies that benefit from that cheap labor are supposed to police it.

I've yet to see one of those companies in China file a complaint where a worker's rights were violated. I've yet to see them talk about it out loud. They benefit from it. So the system that we're dealing with is rigged, and that has to come to an end.

We said they should have put enforceable mechanisms into the accession agreement; we stand by that. Unfortunately, they didn't. Now, we have to do what we have to do, and strong enforcement would be a good start, because if you don't, the Chinese will bleed us of our technology, our know how, and we'll still be seeking, urging, engaging, monitoring, pursuing, clarifying and discussing.

Co-Chair REINSCH. Thank you.
Commissioner Mulloy?

Co-Chair MULLOY. Mr. Kapp, I thought you and Mr. Becker were engaged in a very interesting discussion.

Senator Schumer and former Assistant Secretary of the Treasury under Ronald Reagan Paul Craig Roberts have written a very provocative article making that case that Ricardo's theory of comparative advantage doesn't work when you have mobile factors of production, and you can move capital around the world so readily that people in these other countries can produce much cheaper and ship it back here, and that trade in those cases may become a zero sum game.

But, you know, that may require some rethinking of our national strategy of our trade and where we're all headed. But we're not there. We have to deal with what we have right now. So what I wanted to get Mr. Carlson's view on and Mr. Trumka, Mr. Kapp, in your testimony, you note about—that the currency issue and the fact that the PRC pegs its currency to the dollar so that we don't get a market rate for it, and this has been a big concern among many people that we have an undervalued yuan versus the dollar, and that this permits them to sell more cheaply in our market; makes it more difficult for us to sell in their market.

My understanding is that the Administration, we were told that this morning, the Administration believes this, and, in fact, Mr. Armitage just raised this issue with the Chinese when he was there last week. And Secretary Snow, in a hearing before the Banking Committee, said this was a big issue and that he was pressing at very high levels of the Chinese government.

Mr. Carlson, do you think this is a real issue, and does it affect your farmers, and I'd be interested in Mr. Trumka's view on that, and then, Mr. Kapp, if you want to offer your own view on why you think it's not such a big matter.

Mr. CARLSON. It certainly does affect agricultural producers, the exchange rates, currency values between countries that trade with each other. We have university studies to demonstrate that that is the case, and if you'd like, I can get you copies of those sent to you later.

Co-Chair MULLOY. That would be very helpful. We'll put them in the record.

Mr. CARLSON. But certainly, you can see it dramatically. It's one reason our U.S. exports are up recently of our bulk commodities. It's because the dollar has declined with respect to the euro, to even the Canadian dollar, even to some of the South American currencies.

The Chinese currency, certainly, from everything I read appears to be undervalued, making their exports more competitive. If it was allowed to float at its true value, perhaps our U.S. ag products would appear more attractive. Food, in many cases, as I'm sure you know, is a different product. Every nation desires to be self-sufficient. We see some odd things happening. Cotton exports are increasing to China. That cotton is coming back to us, I think, in manufactured t-shirts with names of our universities probably stamped on the fronts of them, so forth.

So we have some odd things happening for a number of reasons, but one of them is the disparity and the lack of transparency in how currency values are determined.

Co-Chair MULLOY. Thank you.

Mr. Trumka?

Mr. TRUMKA. We think there's absolutely no question that they are pegging their currency. All you need to do is take out the Wall Street Journal, pick out any month, go through five or six years and look at the yuan compared to the dollar. It doesn't fluctuate. Every other currency fluctuates up and down; it's constant.

We've joined an alliance with a number of businesses, the National Association of Manufacturers, a number of other businesses from the Midwest and the South to actually urge the Government to file a section 301 case on currency, and short of that, we will pursue everything that we can legally.

We think that it gives them a tremendously unfair advantage. Economists predict that it's anywhere from 15 to 40 percent undervalued, and that's a 15 to 40 percent advantage over anybody else. And put me in a marketplace and hold everything equal and give me a 15 to 40 percent advantage, and if I can't beat you, shame on me.

Mr. KAPP. I want to come back to the point that Commissioner Becker made.

I feel that the political flap that has arisen since the spring of 2003 and in the summer and fall of 2003 on the currency is misguided; you cannot imagine any remotely practical revaluation that the Chinese might undertake which would address the issues that led to the U.S. political flap in the first place.

The political flap in the first place is what George Becker is talking about; that is, the real, essential element there. If the Chinese raise their RMB 20 percent against the dollar, is that going to eliminate the issues of offshoring and moving production abroad? Of course, it's not going to. Such a revaluation is larger than most observers would consider even remotely possible, but even if it took place, would the dislocations that have led Americans to appeal to their political leaders over the past year be eliminated? I understand, further, that approximately 65 percent of the value of the Chinese processed exports that are shipped to the U.S. is accounted for by the imported parts and components that China buys from Korea and Taiwan and other places. They bring them into the PRC—the shoe tongues or the chips or the disks or whatever—they process them with Chinese labor and they ship them off to the United States.

Sixty-five percent of the value is accounted for by imports. If the RMB rises against the dollar, all of those dollar-priced imports to China get cheaper for China. So don't think for a minute that a 25 percent rise in the RMB is going to mean prices for Chinese goods entering the United States will go up by 25 percent. It just doesn't work that way.

Now the other thing to say is on this "15 to 40 percent" thing. First thing, any economist who says, you know, this currency is undervalued by 40 percent; I mean, come on.

Mr. TRUMKA. No, no, they're different economists.

Mr. KAPP. No, no, it's the same guy. In one case, it's the same guy. I would call your attention to the report of the Congressional Research Service from late December 2003, the expanded report on the RMB peg, implications for the U.S. and Chinese economies, which speaks specifically to the failure of the economic method that led to that 15 to 40 percent number.

The number takes off; somebody says it; it spreads; everybody's got it in his bag; everyone hauls it out at hearings, hauls it out at media events, and pretty soon, the Chinese currency is undervalued by 40 percent. Go back and read the CRS study; then, read the testimony of the Congressional Budget Office director to the House Ways and Means Committee on October 20th of last year.

And finally on this matter, well, no, that's enough. I'm taking too much time.

Co-Chair REINSCH. Thank you.

Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

We were just in South Carolina last week for a hearing. Of course, that's the state of the buggy whips, you know, all the buggy whip industries that need to be replaced by advanced industries, according to some folks.

The attitude of a growing number of people out there is that there's something wrong with the level of protection the United States Government is giving their industries. Now, protection, of course, that word is supposed to be a bad word in the context of trade; but, you know, in the context of the environment, our environmental agency, EPA, Environmental Protection Agency, Department of National Defense, it's all right in other areas but in trade.

I think it's clear that it's the United States Government, obviously, that has to do the enforcement of our trade laws. I think it's a cop out to criticize representatives of the business community for not enforcing trade laws that are written by the Government for the purpose of protection of the American people.

So I think that, you know, we have to look to the Government. Now, my question is, do you as a group think that the United States Government has, in fact, done an adequate job in enforcing the trade laws that are on the books?

I say that in that Senator Hollings, who testified before this Commission last week, announced he was going to be offering a bill that would establish a new, I guess, assistant attorney general level of position in the Department of Justice for trade enforcement; in other words, a full-time, high-ranking U.S. Government official who would be there for the purpose of enforcement.

Incidentally, there were some representatives of the Executive Branch before us this morning who thought that might be a good idea, in that there was no trade official in charge of enforcement in our Government.

What would be your—each of you, Bob, Mr. Trumka, Mr. Carlson, what would be your view of the establishment of such a position through that type of legislation? Anyone?

Mr. KAPP. Those of you who have worked on the Hill, as so many of you have at such high levels, know this better than anybody else. The issue is, if it's the duty of the United States Government

and the Executive Branch to protect the American people, what, exactly, in every case, constitutes the necessary protection?

We saw this on steel. We saw it on steel. No matter which side of the issue you were on, there was a legitimate case to be made, or at least some people would say that the need to take the necessary measures of restricting U.S. markets or increasing tariffs to prevent the damage being done to the American steel producers was a very important need perceived by many people in both the Legislative and the Executive branch, and, of course among those in the industry.

Action was taken. Then came all the steel users who said—“Wait a minute: we’re Americans, too. We’re getting hammered by this. We’re getting killed by this.” So it’s not a question of whether the United States should or shouldn’t protect the American people in the international economy. The question, is in every given case (none of them free of politics, but nevertheless, cases where you can make substantive arguments on the pro and the con side), what the decision ought to be, what constitutes that necessary protection of the American people.

Of course we all agree that the U.S. Government should protect the American people in the international economy. But exactly what that constitutes is over and over again the problem.

Let me imitate the master here, my fellow witness Mr. Trumka, and turn to a subject that I want to talk about that relates to this. Take the case of visas for foreign nationals entering the United States for legitimate business reasons: customers coming over to check out the equipment that they’ve already ordered; pilots coming in to pick up planes and fly them home; people going to trade shows; employees of American companies working abroad who are brought back to the United States for sales meetings or corporate strategy sessions or other company business, to bring all of the different markets together at headquarters and talk about how they’re going to advance their work.

We all know—this is not the hearing for it, but we all know there are problems with the visa system that have made it very, very, very much more difficult for foreign nationals from many countries, including China, seeking to come to the United States on B-1 or B-2 business visas to get in here for their business purposes.

On this “visa mess,” as I call it, the notion of collateral damage has not yet begun to be assessed. It is a national security issue. It all began in the summer of 2002. Regulations went out to tighten massively the process by which applicants for travel to the United States are processed and, in many cases, delayed or denied, and it has been very disruptive to business.

At some point, even on this question, we’ll get to the point where somebody says, “Wait a minute! We’ve got to balance the costs and the benefits here. There are multiple factors you’ve got to weigh in deciding what the best policy is.”

Now, I have gone off on a tangent of my own, because it’s something we work very hard on and that is important to the business community. But it illustrates the same point. Should the American Government protect the people of the United States in the global economy? Yes. Exactly what form that takes on a specific issue—

pedestal actuators, brake drums, ductile waterworks, bedroom furniture, whatever it is, that's a different question.

Another agency of the Executive Branch? Why not. We've got Commerce; we've got USTR; bring in the Justice Department. It's fine with me.

Vice Chairman D'AMATO. So you don't think there's a legitimate issue in terms of the enforcement of the trade laws by the Executive Branch?

Mr. KAPP. The enforcement of the law—

Vice Chairman D'AMATO. That exists; the laws on the books.

Mr. KAPP.—is the function of the Executive Branch at all times. That's a rhetorical question.

Vice Chairman D'AMATO. No, I think it's a practical question. Do they enforce the laws? Is the WTO being enforced through the actions of this Government or not? I think all of these laws, the question of enforcement here is—goes a long way toward the question of whether the U.S. Government is representing the interests of its citizens.

Forget about the question of steel or not steel, but are laws on the books; I think there's a legitimate issue here. And that is what Hollings is addressing in terms of this legislation. You know, the question, do the American people think they're getting enough out of their Government in terms of the laws that are on the books; that's the question I have.

Mr. CARLSON. If I could respond to that.

Vice Chairman D'AMATO. Yes.

Mr. CARLSON. And I would say no, and I would say no, not directly because it's anybody's fault currently but because we rushed into this trade agreement, PNTR and China's WTO accession, without having a baseline of knowledge in the case of agricultural products as to what they do in China.

They agreed to reduce domestic subsidies and supports. They agreed to eliminate export subsidies. We don't, yet to this day, really have a clue or a means to find out what are their domestic policies of support? How do they find new ways to, in effect, provide export subsidies?

Our TRQs are filled by some products that turned around get processed, manufactured into other products, and reexported to us. Well, that gives them a competitive advantage, because they've allowed some products in without any duties whatsoever.

Finally, just let me say, as Mr. Kapp has done, that in the case of exchange rates, they do apply directly, very directly, to raw agricultural products, and the fluctuation in exchange rates applies in an extremely direct manner to the competitiveness of ag products, because they're not manufactured, and parts aren't used in other places.

Vice Chairman D'AMATO. Thank you.

Mr. Trumka, do you have a—

Mr. TRUMKA. I think that the Government has not done enough to enforce the existing laws, and I'd point, I think, as one classic example, to what Mr. Carlson just said: the Chinese government agreed to eliminate export subsidies. They had two deadlines where they were supposed to give us a list of those export subsidies, one in 2002 and 2003.

We're still waiting. Now, if you can't even get the preliminary data to allow you to enforce the laws, you are not enforcing them. I don't know whose fault it is. I just know that the effort is woeful, and it's not being successful at all.

Co-Chair REINSCH. Thank you.

Commissioner Robinson?

Chairman ROBINSON. Mr. Co-Chairman, I'm going to yield the balance of my time. I wish to make just one point, Mr. Kapp, on your visa issue: I think it would also be helpful if our Chinese friends would be less engaged in prolific industrial espionage and technology theft activities that would likewise contribute to the perception that this problem could be remedied in a more sensible fashion.

With that, I'll pass on the gavel to Co-Chairman Reinsch.

Co-Chair REINSCH. Thank you. Very gracious.

Commissioner Dreyer?

Commissioner TEUFEL DREYER. I'd like to ask you to take a little longer view for the moment and consider what things are liable to look like some years from now; pick your time frame, but it's 10, 15, 25. Can the Chinese economy sustain this level of growth? If not, what level of growth do you expect it to level off at? And what do you expect the situation will look like in terms of employment, of factory movement, of labor movement in the United States?

And could we start with Dr. Kapp?

Mr. KAPP. I think I have to emulate Commissioner Robinson, Commissioner Dreyer.

I am not enough of an economist even to give you an economist's answer, which could never be proven right or which would always be matched by another answer from a different economist anyway.

I have a certain feeling, just because I'm old enough to have lived for quite a while, that countries don't grow at 9 percent forever. Things get out of whack bottlenecks occur, overbuilding takes place, overproduction, overcapacity is built, shakeouts occur. We see it in our own economy; we've seen it over and over again; we've seen it in other economies, too.

So I, as a matter of late middle-aged faith, don't think that the trend of the last two years is somehow written in stone for the next 20 years with China. We know that a very high rate of growth is essential to the absorption of the tremendous numbers of people entering the work force, to say nothing about all of those who have been laid off, the 20 million that have been laid off in the last few years because China has been dumping state-owned enterprises and moving more to sink or swim market economics to begin with.

I try never to assert what thoughts, psychological states, or motivations occupy the minds of Chinese leaders. I don't want to tell you I know what they are thinking. That habit, something Americans indulge often when discussing China's political behavior, is generally an exercise in futility or opportunism.

But I do think that the economics would suggest that a very high rate of growth is necessary to try to keep up with the population dynamics in China, and that China's political leadership recognizes that.

So then, we could say, you get into very serious questions indeed. I love coming back to George Becker here. Let's just imagine that

it became the stated policy of the United States (I come back to my 2001 testimony) that the economic growth of China is inimical to the interests of the United States and that the United States should dedicate itself to slowing down and interfering with that economic growth.

If you did that, because I think those are some of the questions that we really get to in Commissioner Becker's musings at the beginning of this dialogue, then, what are the consequences of a diminished or even stagnant Chinese growth rate? Then, you get into large questions of refugee flows and the possible flood of products into U.S. markets, and so forth and so on. Logically, the answer is getting the Chinese to the point where they have a per capita GNP of \$25,000, because then, they'd all be consuming and using the same things we do, and we'd all be trading like modern mature nations.

But you know and I know that that's a very long way down the line, given the poverty of the country and the size of the population. I can't go beyond that in terms of a picture of 20 years out.

Commissioner TEUFEL DREYER. Thank you.

Mr. Trumka?

Mr. TRUMKA. Well, if you look a 10 years, perhaps. If nothing changes in the letter of the law or the enforcement of the law, things will continue; we will continue to see a draining here, they will continue to violate their treaties.

And unwittingly, I think Mr. Kapp gave you the answer to that. He said there will be tremendous pressure on them to continue growth. The more pressure there is for them to continue the growth, the more pressure for their Government not to allow us in and to keep violating the rules so that they can be growing domestically. That's the answer.

And if you want to increase income, in 10 years, it won't increase, because independent unions are still illegal in China; in 10 years, if nothing changes, they will still be illegal in China, and the worker will not be able to increase their standard of living and become a more consuming society, because they won't have the per capita income to do that.

Commissioner TEUFEL DREYER. And of course if the Gini coefficient continues to widen, they're not going to have larger numbers of consumers. But again, that's one of those variables that Dr. Kapp said was so hard to quantify.

Mr. KAPP. First of all, Mr. Carlson hasn't spoken yet, but if the Commission will permit me, I would like to say something after Mr. Carlson in relation to what Mr. Trumka just said.

Commissioner TEUFEL DREYER. Mr. Carlson?

Mr. CARLSON. Very briefly, we were in China in the year 2000, in the fall of 2000. They have 700 million people living in the countryside, not in the cities, living basically on farms or in farm villages. And they're concerned, as we talk to their Ag Ministry deputy type level people, about dislocations of all sorts that would occur if they didn't keep a large proportion of their population involved in growing agricultural products.

They told us, and they seem to have followed it with some success that they didn't intend to become exporters in the bulk grain commodities. They wanted to be self-sufficient. But they did want

to reorient their agricultural production, especially in the East Coast of China, where we toured up and down, toward more high valued export products: fruits, vegetables, pork and poultry.

They seem to have had some success in doing that. We've seen, for example, most of the garlic and most of the asparagus, for example, that you buy in your grocery stores probably comes from China. In fact, we've had significant cuts in U.S. asparagus production because of that.

So, I expect for social reasons, they need to maintain agricultural production, and to garner some foreign income, they're going to go after those high-value ag products, and, you know, they've got lots of labor to do those things.

Commissioner TEUFEL DREYER. Back to Dr. Kapp.

Mr. KAPP. I hope Mr. Trumka won't think of this as a really offensive rebuttal.

It does seem to me that the economic growth that we've seen in China in the last 15 years, though, was not because the Chinese set about keeping the foreigners out so that they could grow; it was the opposite. The growth has occurred in significant measure because they threw themselves into the world economy, both in terms of welcoming investment to a degree that, of course, dwarfs anything that happened in Japan, and also in terms of trade.

This is not an economy which is growing at this massive rate because they're isolating themselves from the foreigners. There are restrictions; absolutely, and we're trying to fight them down through the WTO. (In this regard, I should mention the issues facing the U.S. fertilizer industry; I apologize for not mentioning fertilizer before.)

Mr. TRUMKA. There's plenty up here today.

Mr. KAPP. Plenty of fertilizer? I'm putting out a little right now. It's just a general point, i.e., that this growth is rooted in a massive engagement with the world economy that, in fact, China did not engage in when they were stagnating in the sixties and seventies.

Commissioner TEUFEL DREYER. Does Mr. Trumka have a brief rebuttal to that?

Mr. TRUMKA. That is precisely the point. They want us to come there and produce there. They don't want us to be able to produce here and send products there. So the more pressure there is for them to grow, they will welcome us with open arms. They will welcome our capital, they will welcome our technology, they will welcome our know-how. They will welcome everything but stuff that's produced here.

Co-Chair REINSCH. Before yielding to Commissioner Wortzel, I'll just reflect on something that Senator Hollings said in South Carolina that struck me. Senator Hollings was one of our early witnesses, and one of the comments he made was that the Chinese are doing exactly what is right for them to do for themselves. And he wasn't about to blame the Chinese for what they were doing, because he thought they were being smart. He was blaming, in his view, us for not being equally smart.

So I will just throw that out for what it's worth.

Commissioner Wortzel, last but not least.

Commissioner WORTZEL. Last but not least; thank you.

Thank you; Mr. Carlson, I will start with you if I may. I was intrigued by the discussion in your testimony on maximum residue levels for vomitoxin. And I have a question for all three Commissioners, so I'll just shoot all three out, and then, you can respond.

For Dr. Kapp, in the U.S. China Business Council's written testimony assessing the second year WTO membership, the council graded China as 5.2 or C overall in its implementation, with 1 as excellent and 10 as failure. I'd just be interested in, today, whether you would move the grade at all. How do you grade it today? Is there a change in what the Council graded it before?

And then, finally, for Mr. Trumka, I two different arguments with respect to labor from you. One is, let's get jobs back here, and the second is about labor rights and labor standards in China. It seems to me that one of the most subversive things that American labor could do would be to get real, live, union member-first line supervisors on some of these production lines out in China.

They could set an example, treat people decently, and talk about labor rights and organization. And I know that many of the foreign joint venture companies that I've run into in China go to Singapore, Taiwan and Hong Kong to get their labor supervisors, because they get better quality, better standards of quality, better supervision, more professional stuff than they can get from Chinese citizens. Foreign supervisors don't get involved in the little graft that goes on with the Communist Party.

So I wonder if the AFL-CIO has a language-training program for members who might be interested in working in China and taking supervisory jobs? The salaries over there for foreign line supervisors are pretty good, so that union members or union supervisors who might be interested in doing that could have the opportunity to compete for those jobs.

Thank you.

Mr. CARLSON. First, with regard to vomitoxin, vomitoxin is a fungus, a plant fungus. I don't recall the scientific name right offhand. The lay term for it is vomitoxin, which is not a very marketable name, I'll grant you. It makes, in wheat, for example, the kernels affected by vomitoxin are sort of chalky looking. And there are no international standards for maximum allowable percentages of vomitoxin. Millers, especially of pasta products, do not like vomitoxin, because it threatens the strength and integrity of, say, a piece of spaghetti.

In barley, vomitoxin allegedly—it makes you get price discounts for trying to sell barley with vomitoxin, because it allegedly makes beer cloudy.

But to my knowledge, and I'm not a scientist, it has no ill health effects. Generally, vomitoxin in a grain, if it doesn't have desirable milling characteristics for flour or beer, would be used as feed.

Co-Chair REINSCH. It's a hard act to follow, Mr. Kapp, but it's your turn.

Mr. KAPP. That grade was a function of a poll we did of our members and of a weighting done by the member of our staff who designed the poll. Commissioner Wortzel, the main point is that that survey was done only three or four months ago. I really think that the exercise of taking the temperature of China's WTO performance every three months is just not that productive.

We can get together and discuss what we like and don't like. But to try to measure the patient's condition on a three-month basis when you're looking at economic and social processes that are so large—I think once a year is appropriate, and the Congress has mandated it, and it is appropriate that we all do our best once a year.

But have I gone back to all of those people who wrote the poll in September and said, "Please take the poll again for my meeting with this Commission on February 5?" The answer is no.

I might add a word in regard to Commissioner Wortzel's question to Mr. Trumka. I might say we created some years ago a little fund drawing financial support from the corporate members of our Council called the U.S.-China Legal Cooperation Fund, and which has by now given out nearly \$1 million in support over four or five years to help U.S. and Chinese cooperating participants in good projects in the area of law, widely conceived.

Among those projects, we were delighted to give two different grants to the International Labor Rights Fund for very good work, and one, interestingly enough, to a small project undertaken by someone in California whom I'm sure Mr. Trumka knows, a person I've never met personally; I think he's at UCLA, named Kent Wong, who proposed bringing together of people from the Chinese All-China Federation of Trade Unions (which doesn't have the best odor in the AFL-CIO, as far as I know), with certain representatives from the American labor community who went over to China to explore areas of mutual or parallel interest.

We thought that it was at least a hopeful sign that perhaps some greater dialogue could be undertaken in that way, but I can't tell you what the long-term results would be.

Mr. TRUMKA. First of all, it's not just the AFL-CIO that doesn't believe that the ACFTU is a real union; it's the ILO that also doesn't believe that it's a real union and doesn't really represent workers.

To answer your question, we expend considerable effort in trying to help the Chinese workers. We have exchange programs where we bring people from China over here, and we train them. Kent Wong, who was the head of one of our affiliated groups for a number of years, the Asian Pacific American Labor Alliance (APALA) would bring people back and forth, train people, send them back.

We also have right now an office we're opening in China itself to enforce workers' rights. There are a number of statutes on the books in China that we want to improve enforcement on—we have a couple of lawyers over there that are actually helping to do that. Now, you can't talk about unions, because unions are illegal, but the actual training of people here to send them over there, I can honestly say no one has come to me and said train me in Chinese so I can go to China and get a job.

I think they still would rather be trained in English and work here in this country, because that's where their roots are.

PANEL IV: INDUSTRY, TECHNOLOGY, INTELLECTUAL PROPERTY

Co-Chair REINSCH. Thank you very much. Thank you to the panel. A good discussion.

Let's move on to the next panel. As I've indicated in the beginning, the next panel is Bill Primosch, Director of International Business Policy for the National Association of Manufacturers; Eric Smith, President of the International Intellectual Property Alliance; Anne Craib, Director for International Trade and Government Affairs for the Semiconductor Industry Association; and Ann Wroblewski, International Vice-President of the International Forest and Paper Association.

[Pause.]

Co-Chair REINSCH. If the panelists will take their seats, we're ready to resume.

I appreciate your forbearance for a few minutes. For those of you that weren't here, I will repeat the rules. Your full written statement will be entered in the record. We're asking each of you to confine your oral remarks to seven minutes each. We'll have all of you testify, and then, when you're done, we'll have questions for the whole panel. And as I indicated to my fellow Commissioners, who actually are coming back, I'm going to begin at this side, with Commissioner Wortzel, and work around that way for the question and answer period.

So with that, we'll begin, and we'll go in the order in which I introduced you, which means we'll begin with Mr. Primosch.

**STATEMENT BY WILLIAM PRIMOSCH
DIRECTOR OF INTERNATIONAL POLICY
NATIONAL ASSOCIATION OF MANUFACTURERS**

Mr. PRIMOSCH. Thank you, Mr. Chairman and Members of the Commission for giving the National Association of Manufacturers the opportunity to testify today on China's WTO compliance.

The NAM represents 14,000 manufacturing companies, and we hear more from our members about trade with China than with any other country. What makes China unique, of course, is the large size of its economy, the rapid expansion of its industry and its emergence within a relatively short period of time as a global competitor and an important emerging market for U.S. exports.

The NAM supports open markets and does not insist on balancing trade. But in China's case, we believe that a substantial part of our large bilateral trade deficit, which amounted to about \$123 billion last year, results from unfair trade and currency practices that give Chinese exports a competitive advantage and artificially limit China's imports of U.S. goods and services.

And so, that's why China's membership in the World Trade Organization is so important. It provides a critical tool for leveling the international playing field with China and ensuring that China plays by the same trade rules everyone else does.

As China begins its third year of WTO membership, the NAM has serious concerns about Chinese compliance with both the letter and spirit of its WTO obligations. China has apparently made good on its commitments to reduce tariffs according to the agreed schedules. It has also published new regulations and laws as required by its membership agreement, for example, on improving intellectual property rights protection.

However, overall WTO implementation has been spotty, often ineffective, and marred by new measures that have created a variety of new trade problems. NAM members have identified a variety of

Chinese policies and practices that are matters of concern and that appear to violate WTO obligations. I have highlighted several important categories in my prepared statement, including apparent production subsidies, violations of intellectual property rights, manipulation of value-added taxes to create unfair advantages, inappropriate technical standards, problems with the CCC quality mark system, restrictions on U.S. companies' export and import rights, and unjustified product labeling requirements.

However, by far, the biggest complaints we hear from manufacturers relate to China's undervalued currency and large-scale counterfeiting of U.S.-trademarked products and I would like to focus my remarks this afternoon on those two issues.

China's undervalued currency is so important because it affects all of our exports to China and all of our imports from China. The Chinese yuan is widely considered by economists to be undervalued. Estimates run as high as 40 percent or more. And pegging the yuan to the dollar appears to be part of a deliberate strategy to limit import competition and boost exports, particularly of manufactured goods.

This kind of currency manipulation goes against the intent of the General Agreement on Tariffs and Trade, specifically Article 15 that addresses exchange rates. China should have an exchange rate determined by the market and not Government intervention. As a first step, we urge, as Secretary of the Treasury John Snow has suggested, that China revalue the yuan to some level closer to its true market value and then eventually move to a floating exchange rate.

The other problem that affects a broad range of manufacturers is the counterfeiting of U.S.-branded products. Counterfeiting is rampant and on a massive scale. It occurs on a wide range of manufactured products, including consumer hygiene and health products, athletic footwear, pharmaceuticals, food and beverages, motorized vehicles, auto and truck parts and even entire automobiles.

Pharmaceutical counterfeiting, now according to U.S. industry representatives, is a serious public health problem in China, as counterfeit products are not only improperly formulated but also contain ingredients hazardous to human health.

To effectively address the problem, the Chinese must enact laws that punish counterfeiters with criminal penalties, including jailing; permit the destruction of counterfeiting equipment; clarify the law to make the export of counterfeit products illegal, just as the internal sale are, and make it easier for trademark owners to file complaints and request customs service action to block exports of counterfeit products.

The NAM welcomes increased efforts by USTR and the U.S. Embassy in Beijing to bring greater attention to counterfeiting problems, but we are now looking to see whether these efforts are going to result in concrete progress.

Our overall assessment of U.S. monitoring of Chinese compliance is that it's good, and it's getting better. Ambassador Zoellick, Deputy Trade Representative Shiner, Commerce Secretary Evans, and Undersecretary of International Trade Aldonas, and their staffs are to be commended for raising the profile of WTO concerns over the past year.

Notwithstanding these good efforts, though, the scale of the trade and currency problems with China require a much more intensive U.S. Government monitoring, extensive staff resources and continuing efforts to engage China at the most senior levels of both government and business. The need for more technical expertise to deal with complex issues such as counterfeiting and technical barriers to trade is particularly pressing.

Finally, as part of U.S. efforts to improve China's WTO compliance, the Commission rightly notes that we can gain increased leverage by working with foreign governments and business organizations. We strongly agree and urge the Administration to make cooperation on China's WTO compliance an integral part of dialogue with key trading partners such as Japan, South Korea, Taiwan, the European Union and individual EU members.

The NAM has raised concerns about China trade concerns with several foreign counterpart business organizations, notably the Confederation of British Industry and the German Industry Federation, and we found that European industry is only just beginning to focus on China trade issues, and this is partly because Europe imports significantly less from China than the United States, and they export significantly more, particularly of manufactured products.

But we sense a growing appreciation of the challenges arising from trade with China and a willingness to work more closely with us. We are pursuing a dialogue with these organizations and are going to step up those efforts, and we urge the U.S. Government to do the same with their counterparts.

Thank you.

**Prepared Statement of William Primosch
Director, International Business Policy
The National Association of Manufacturers**

Hearing Co-Chairs and Members of the Commission,

Thank you for giving the National Association of Manufacturers (NAM) the opportunity to testify on China's WTO compliance and U.S. Government monitoring efforts.

The NAM represents 14,000 manufacturing companies, both large corporations that do business around the world and over 10,000 small and medium-size firms, including many successful exporters and others which concentrate on the domestic market. For large and small companies, the future of U.S. trade with China is of great commercial importance. And we hear almost daily from companies that are affected by that trade, either to express concern about Chinese trade and currency practices or interest in expanding their business there. With an economy growing 8 percent a year and a rapidly expanding industrial base, China has emerged within a short span of two decades as an important competitor of U.S. manufacturers and a key emerging market for U.S. manufactured goods exports. In 2003 China exported \$438 billion in goods, mainly manufactured products, making China the world's fourth largest exporter. At the same time, high rates of business and government investment and rising personal incomes have fueled a strong demand for western products and services for which the United States is highly competitive. China imported products valued at \$413 billion in 2003, an increase of 40 percent over 2002.

While China ran a relatively small trade surplus with the world, the trade imbalance with the United States was highly skewed in China's favor. Chinese exports to the U.S. in 2003 were valued at approximately \$150 billion and imports, approximately \$27 billion (U.S. Department of Commerce data). As China produces most of its manufactured exports from parts and components made elsewhere in Asia (e.g., Japan, South Korea and Taiwan), these economies also benefited substantially from the large U.S.-China trade imbalance.

The NAM does not insist on balancing trade between countries. But in China's case, we believe that a substantial part of the trade imbalance results from unfair trade and currency practices that give Chinese exports an advantage in the U.S. and foreign markets and artificially limit China's import of U.S.-made products and services. That is why China's entry in the World Trade Organization (WTO) in December 2001 was so important for U.S. manufacturers. It provides an important tool for ensuring a level international playing field with China on trade.

In its WTO accession agreement, China committed to open its internal market further to U.S. and other foreign products and services. It has also agreed to bring its trade and business practices in line with WTO rules and agreements. Both aspects are important for U.S. manufacturers. The NAM supported China's membership in the WTO and Permanent Normal Trade Relations (PNTR) status with the understanding that the U.S. Government would press China to adhere to its WTO commitments and become a responsible participant in the international trading system.

Overall Assessment on Compliance

As China begins its third year as a WTO member, the NAM has serious concerns about Chinese compliance with both the letter and spirit of its WTO obligations. China has apparently made good on its commitments to reduce tariffs according to the agreed schedules. It has also published new regulations and laws required by its membership agreement. Implementation of these measures, however, has been spotty and often ineffective. U.S. manufacturers continue to encounter a variety of market access barriers that limit their ability to export and do business in China notwithstanding steps taken by the authorities to implement market-opening commitments. At the same, U.S. producers focused on our domestic market express concern about Chinese trade and currency practices that tilt the playing field in China's favor and appear to violate WTO obligations.

These trade problems and the rising trade deficit with China come at a time when U.S. manufacturers have yet to recover from a 3-year long economic slowdown and remain concerned about their longer-term prospects. Since July 2000 the manufacturing sector has lost nearly 3 million jobs, and some industry segments continue to reduce employment levels in the face of weak demand.

NAM members recognize that China is still in transition to a market economy and in the process of phasing in certain WTO market-opening commitments. However, because China has quickly become such an important global importer and exporter, it is vital for American businesses, workers and farmers that the U.S. Government ensures China complies fully with all its WTO obligations and that it takes effective action when China fails to do so.

Specific Issues of Concern

NAM member companies and associated organizations have identified a variety of Chinese policies and practices that either provide Chinese exporters with unfair trade advantages or create significant barriers that hinder market access for U.S. products. China's undervalued currency and large-scale product counterfeiting are the two most frequently cited problems in our bilateral trade. The following section provides more details on individual issues of concern.

Currency Manipulation

The NAM has received the greatest number of complaints about China's deliberate policy of undervaluing its currency, which gives Chinese products unfair competitive advantage over U.S.-made products. Economists have estimated that China's currency could be undervalued by 40 percent or more. The Chinese yuan has remained pegged to the dollar at an exchange rate of 8.28 for the past nine years despite an extended period of robust economic growth, continuing trade surpluses and a large build-up in foreign exchange reserves, which now total \$403 billion—\$117 billion more than a year ago. This level of foreign exchange reserves is, according to IMF analysis, far in excess of what would be required to cushion China's balance of payments from normal fluctuations in trade and investment flows.

Pegging the yuan to the dollar appears to be part of a deliberate strategy to limit import competition and boost exports, particularly of manufactured goods. This kind of currency undervaluation for commercial gain goes against the intent of the General Agreement on Tariffs and Trade (GATT), which seeks to remove trade barriers and allow markets to determine trade flows. Article IV of the GATT states that "Contracting Parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement. . ." China's undervalued currency acts as an additional trade barrier to U.S. exports and an unfair subsidy for all Chinese exports.

The NAM believes that Chinese exchange rate policies are not in accord with WTO obligations and in violation of Section 301 of the Trade Act of 1974. On Jan.

29 the NAM announced that it was supporting a decision of the Fair Currency Alliance, a group of associations and unions representing manufacturing, agriculture and labor, to develop a Section 301 complaint against China for currency manipulation. We believe that China should have a flexible exchange rate determined by the market and not government intervention. As a first step, we urge, as Treasury Secretary John Snow has suggested, that China revalue the yuan to some level that more closely reflects its true exchange rate.

The NAM appreciates efforts by the Bush Administration, particularly Secretary Snow, to raise the importance of market-based exchange rates with Chinese leaders and obtain unprecedented support from other finance ministers in the G-7 and APEC. We are confident that a more flexible market-based exchange rate would result in a significant appreciation of the yuan against the dollar and help to level the playing field with Chinese producers both here at home and in the global marketplace. We strongly urge the Administration to continue pressing the Chinese government to break the current yuan-dollar peg and allow the yuan to move up to its true market value. China's undervaluation of the yuan is distorting trade not only with the United States but with other countries as well. As President Bush said recently in commenting on U.S.-China trade, the Chinese "have got to deal with their currency." We agree.

Counterfeiting and Ineffective Enforcement of IPR Protection

The counterfeiting of U.S.-branded products and other violations of intellectual property rights are serious and growing problems in China. While Chinese laws on intellectual property rights (IPR) have improved considerably, the lack of consistent and effective enforcement by local governments has severely limited the ability of U.S. companies to protect their intellectual property rights.

Violations of trademarks through product counterfeiting is rampant and on a massive scale. The violations involve a wide range of manufactured products, including consumer hygiene and health care products, athletic footwear, pharmaceuticals, food and beverages, motorized vehicles and vehicle parts, and even entire automobiles. Pharmaceutical counterfeiting is now, according to U.S. industry representatives, a serious public health concern in China. We believe that the lack of criminal penalties for counterfeiting, including jailing, prevents effective enforcement of trademark and labeling violations.

We are also concerned about reports that local government authorities are aware of counterfeit production and taking no action to halt it. There appears to be no mechanism for the national government to force local governments to stop counterfeiting by local industry or prevent them from aiding and abetting such activity.

The failure of Chinese customs officials to block counterfeit product exports is a problem as well. An NAM member company reported that the Chinese customs service refused to cooperate in preventing the export of counterfeit products even when solid evidence of counterfeiting was provided. Chinese officials claimed that, since the "exporting" of counterfeit products did not constitute a "sale" of the products, the relevant Chinese law did not apply.

Other IPR violations are also common. They include: unauthorized duplication of computer software, music and films; copying of designs; unauthorized use of patented technology; and unauthorized use of U.S. product certification and testing logos. The makers of air conditioning and refrigeration equipment note that the ARI (Air-Conditioning and Refrigeration Institute) certification symbol was being used without authorization by a Chinese company. Other U.S. safety and testing marks are also being inappropriately used. Efforts to have the Chinese government stop this unauthorized use have proven ineffective.

The pharmaceutical industry does, however, also report improvements in intellectual property protection, notably by the promulgation of a new regulation on data exclusivity for clinical trials, as required in TRIPS and committed in China's accession package.

The NAM welcomes increased efforts by the U.S. Trade Representative's Office and the U.S. Embassy in Beijing to bring greater attention to the counterfeiting problem and encourage more effective action by the Chinese government. For example, the U.S. Embassy in Beijing organized a highly productive meeting of business representatives and Chinese officials on Nov. 18, 2003, to discuss counterfeiting issues. U.S. Deputy Trade Representative Josette Shiner and China Vice Premier Wu Yi attended the meeting and helped to underscore the seriousness of the problem. Ambassador Shiner and her staff have also actively engaged in a dialogue with affected companies to identify possible solutions, including changes in Chinese law that would permit criminal penalties and confiscation of counterfeiting equipment. We believe that the latter measures in particular are needed if IPR enforcement is to have a meaningful deterrent effect.

Subsidized Exports

We continue to receive reports from different industries (e.g., tool-and-die, metal forming, steel and chlorinated isocyanurates) that suggest Chinese producers are receiving direct or indirect subsidies that give them unfair competitive advantages. Companies report that Chinese products are being sold in the United States at prices so low that they could not even cover the cost of raw materials and shipping much less full production and marketing costs. A tool-and-dye company, for example, stated that a Chinese competitor was selling a product similar to one made in the United States for \$40,000, compared to the U.S. producer's price of \$100,000. The U.S. company maintains that the cost of the raw materials alone would amount to \$40,000, not including shipping, duties and other costs. A U.S. producer of chlorinated isocyanurates, which is used as a cleaning agent in swimming pools, reports a similar situation. As a result of pricing which appears to be below cost, Chinese exports of this product increased by an estimated 400 percent in 2003 over 2002 levels.

These reports indicate the possibility of widespread use of subsidies, either direct or indirect, to help Chinese exporters gain unfair competitive advantage in the U.S. market. They merit further investigation by USTR and the Department of Commerce. One source of indirect subsidy is continued lending by Chinese banks to money-losing or insolvent Chinese manufacturers, often state-owned or state-controlled enterprises. Since the Chinese banks providing these loans are either state-owned or state-controlled, the Chinese government bears responsibility for their lending practices. U.S. steel producers note that the Chinese steel industry is the largest recipient of interest-rate subsidies authorized by the national government. Since many of the companies that benefit from either directed bank lending or subsidized interest rates are engaged in international trade, they have an unfair competitive advantage vis-&-vis U.S. based companies, which must rely on private financing at market rates.

Manipulation of VAT Taxes

We have reports that China is manipulating the application of taxes, notably the Value-Added Tax (VAT), to both restrict imports and indirectly subsidize exports. U.S. producers of semiconductors continue to experience discrimination in the Chinese application of the VAT on imported and domestically produced semiconductors. China levies a 17 percent VAT on imported integrated circuits. Domestically designed and produced integrated circuits are taxed at VAT rates ranging from 3–6 percent. Integrated circuits produced in China but designed abroad are taxed at 11 percent. This discriminatory treatment of domestic and foreign “like” products violates Article 3 of the GATT. Despite repeated protests by U.S. industry and the U.S. Government, this issue remains unresolved.

The scrap recycling industry reports a different kind of problem relating to VAT administration in China. Industry representatives have told us that Chinese users of imported copper and other scrap metals are deliberately undervaluing their invoices to pay less VAT on the imported metal. When the finished metal products are exported, however, Chinese producers claim a rebate of the VAT based on the metals' real import price. This results in a substantial subsidy for the exported product that translates into lower prices in the U.S. market. It also enables Chinese scrap metal users to pay higher prices for scrap metal than their U.S. competitors. Chinese customs and tax authorities have not taken action to investigate these practices. Because China is the world's largest importer of scrap metals and its purchases have a major impact on U.S. and international scrap metal prices (notably copper and steel scrap), its trade practices merit close scrutiny to ensure that they are consistent with international trade rules and accepted practices.

Effective Jan. 1, 2004, China reduced by 3 percentage points the average VAT rebate on a variety of industrial and consumer goods exports. This is a step in the right direction toward leveling the playing field for U.S. manufacturers. However, even the new VAT rates leave many categories of manufactured goods eligible for rebates of 13-17 percent of their value. Since VAT rebates can be easily abused to provide indirect export subsidies, China should be encouraged to consider even further reductions.

Inappropriate Standards and Concerns about CCC Mark System

Several NAM members have raised concerns about China's application of technical standards and the CCC Mark system. One problem relates to China's definition of “international standards” in the internal market. China is requiring that certain products (e.g., electrical products) be manufactured only to “international standards” as determined in the Organization for International Standardization (ISO) or International Electrotechnical Commission (IEC). Other “international

standards,” notably those developed in the United States and widely used in the global marketplace, are not allowed. This does not conform with the interpretation of the WTO Technical Barriers to Trade (TBT) Committee that “international standards” need not be limited to ISO or IEC standards.

A second problem relates to a Chinese requirement for special national technical standards that do not conform to accepted international standards. Recently, Chinese regulatory authorities announced a standard for wireless local area networks (WAPI) that contain unique encryption elements available only to Chinese companies. Thus, the only way U.S. wireless equipment manufacturers can gain access to the encryption is through co-production of the equipment with a Chinese manufacturer. This would require the affected U.S. companies to provide free access to their intellectual property and design specifications. Under the WTO TBT Agreement, China is required to use international standards whenever they are already established. The requirement for special national WAPI encryption elements, therefore, would appear to violate the TBT Agreement. Given the potential commercial importance for U.S. manufacturers of this emerging technology, we strongly urge the U.S. Government to give a high priority to resolving differences with China over the WAPI standard.

A third set of standards concerns relates to the CCC mark system. China introduced the CCC mark system to comply with WTO requirements for a single mark for like domestic and imported products. It is, in that sense, a step forward on standards and mark requirements. However, the inconsistent, non-transparent and inflexible application of the CCC Mark on a variety of products (e.g., electrical products, air conditioning and refrigeration equipment) has created market access barriers and needlessly raised the cost of importing products into China.

Generic problems relating to the CCC mark include: the high cost of having Chinese inspectors audit factories in the United States and other foreign countries on compliance with the standards; continued delays in allowing U.S. testing and certifying bodies to certify compliance for the CCC mark; and lengthy delays and relatively high cost of obtaining testing and certification for the CCC mark in China.

Restrictions on Import/Export Rights of Joint Ventures

China is not fulfilling its commitment to allow foreign joint ventures to import and sell products (e.g., tires, automobiles, auto parts and industrial equipment) in China, which was to have gone into effect on Dec. 10, 2002. In a related matter, a major tire company reports that the Chinese government has still not issued the 2004 regulations on import quotas and import licensing for tires and natural rubber that were due to be published on Jan. 1, 2004. As a result no tires or natural rubber could be imported into China during the month of January.

Unjustified Labeling Requirements

In 2002 the Chinese Ministry of Health promulgated a new regulation mandating the labeling of all genetically modified (GM) food products. While the implementation of the regulation was subsequently suspended indefinitely, the fact that it remains on the books is already having significant adverse economic effects and creating barriers to trade. Some producers have ceased shipping these products in anticipation of the regulation going into effect.

U.S. food producers have questioned whether the Health Ministry’s action was in conformity with China’s WTO obligations. The ministry did not provide a justification for the labeling requirement based on an assessment of health risks, which is a requirement of the WTO Agreement on Sanitary and Phytosanitary Measures. The WTO TBT Agreement also suggests that China is giving inadequate attention to the treatment of “like products,” the question of whether the labeling requirement addresses a “legitimate objective” and the requirement to base technical regulations on “performance” rather than “design” characteristics.

Lack of Transparency in Trade Regulatory Process

Many companies complain about the lack of transparency in the trade regulatory process and the difficulty in obtaining current laws and regulations governing trade and business operations. This is a continuing problem that affects all U.S. exporters and companies doing business in China. The U.S. Government should press for concrete steps that improve transparency at all levels and seek continual progress.

Assessment of U.S. Government Monitoring of Compliance

Given the limited resources available, U.S. agencies, notably the Commerce Department, Office of the U.S. Trade Representative and State Department through diplomatic missions in China, are doing a good job of monitoring China’s WTO compliance. The NAM has noted with satisfaction the increased efforts undertaken by all three agencies in 2003 to identify compliance concerns and maintain an open dia-

logue with business on seeking solutions. We were pleased to see that senior U.S. officials, including Ambassadors Zoellick and Shiner, Commerce Secretary Evans and Commerce Undersecretary Aldonas, have raised WTO compliance concerns with their Chinese counterparts during the past several months. Treasury Secretary Snow's meeting with senior Chinese officials on the undervalued yuan, an issue the NAM believes also falls under WTO compliance, was particularly helpful in raising the profile of this issue. It is vital that the Chinese government understand the importance of full WTO compliance, and regular discussions at senior government levels serve to reinforce that point.

However, given the high level of U.S.-China trade (nearly \$180 billion in 2003) and the current growth rate of 20–25 percent annually, U.S. Government resources are still not adequate to ensure effective monitoring and enforcement of WTO compliance. USTR, Commerce and U.S. diplomatic missions in China require larger and more technically qualified staffs to perform these functions. More specialized technical expertise is particularly important for addressing legal issues involving counterfeiting and intellectual property protection, technical standards and regulations that impede trade, and direct and indirect subsidies to industry that provide unfair advantages. U.S. agencies have established a good foundation to strengthen their monitoring efforts, but clearly more needs to be done to ensure full Chinese compliance with their WTO obligation.

The NAM supports the additional programs and funding for monitoring and enforcing China's WTO compliance that are contained in the Department of Commerce and Related Agencies section of the recently passed Omnibus Appropriations bill. In particular, we welcome:

- Funding for 8 additional positions at USTR dedicated to issues relating to China's WTO compliance;
- The requested Commerce Department study, to be carried out in consultation with the U.S.-China Economic and Security Review Commission, on such important issues as China's industrial policies, exports from state enterprises, means of IPR compensation, professional service outsourcing and the relocation of supply chains in China;
- Authorization of 6 positions in China to support the American Trade Centers Initiative; and
- Establishment of an Office of China Compliance in the Commerce Department's International Trade Administration.

We believe these initiatives will help improve monitoring and enforcement of China's WTO compliance and enhance the ability of U.S. business to take better advantage of a more open Chinese market. And we are grateful to Representative Frank Wolf for recognizing their importance and working so hard to include them in the legislation.

Conclusion

For many U.S. manufacturers, China is rapidly emerging as their most important competitor both at home and abroad. They look to the enforcement of China's WTO obligations as an essential tool for leveling the international playing field. The NAM, therefore, very much appreciates the Commission's work on WTO issues and wants to cooperate with Commission members and staff and others in the Administration and Congress to make China's WTO compliance as effective as possible.

Co-Chair REINSCH. Thank you very much, Mr. Primosch.
Mr. Smith?

STATEMENT OF ERIC SMITH PRESIDENT, INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE

Mr. SMITH. My name is Eric Smith. I'm the President of the International Intellectual Property Alliance. We represent the U.S. copyright industries. I am pleased to have the opportunity to be here today to talk about the perspectives of the U.S. creative industries on China's WTO compliance.

IIPA represents six trade associations, about 5 percent of the U.S. economy, and somewhat over 1,100 companies. You've heard earlier about the problem of counterfeiting in China. It's a huge problem. I'm going to talk a little bit about piracy, which is obviously closely related, and some of the issues are very similar.

We were—IIPA members were at the forefront not only of the 1995 and 1996 Section 301 action against China, and you may remember that's when China faced \$2 billion worth of retaliation if they didn't shut down CD factories that were exporting millions and millions of unit of pirate product all over the world.

That action by USTR was successful. China stopped doing that. And thereafter, we were heavily engaged with the whole WTO accession process in China.

Our conclusion with respect to China's WTO compliance is that there are two principal problems. The first is that copyright piracy dominates the local market almost completely. Piracy rates have consistently been over 90 percent in China for the last 15 years, and that is despite massive raiding and seizures, which I'll talk about in a minute, throughout China and particularly in the Southern part, where piracy has been the worst.

The second problem are very restrictive market access commitments that were made by China in their WTO accession that continue to apply and that hinder U.S. copyright industries from getting into the market in the first place and, of course, being unable to get legal product into the market means that even if you were tomorrow to stop piracy, you would not be able to get legal product in to take its place. So the combination of these two things is very damaging to our companies.

On the issue of piracy, the bottom line is that with piracy rates over 90 percent, China is not in compliance with its TRIPS obligations under Articles 41 and 61 of the WTO agreement, TRIPS agreement. Put simply, the Chinese enforcement system has failed to significantly lower piracy levels in any significant way over the last few years.

Because TRIPS requires China to provide adequate procedures and effective legal remedies to protect copyrights in practice, not just in their statutory law, its failure to make any dent in piracy rates establishes what we consider to be a prima facie case for violation of its international commitments under the WTO.

We estimate losses to U.S. companies through copyright piracy in China to be at least \$1.8 billion annually, and if you add that up over the last 15 or 20 years, it's massive losses to the U.S. economy. That, combined with market access barriers, creates a huge problem for us. Optical media plants in China, including plants that are licensed by the Government, continue to produce pirate CDs and DVDs containing movies and music, games, and there's clear evidence now that underground producers have come back, and they have begun again to export pirate product. There was a period from 1996 to probably 2003 when exports had diminished to a trickle, and now, we're seeing seizures in Italy, UK, U.S., and many countries around the world. It's a very disturbing development. We thought we had that one licked.

Imports of pirate product continue; still a significant problem, but basically, most of the piracy in China is homegrown. Internet piracy is getting to be a huge problem in China. There are now 78 million Internet users. That's reported to be the second largest in the world. When broadband comes to China, the future of our industries will indeed be grim unless the legal and enforcement infrastructure is in place to deal with it.

The Chinese enforcement system is unlike what exists anywhere else in the world. It is the only country that relies on administrative enforcement to deal with these issues. And frankly, the system simply doesn't work. The fines are too low, and there's no deterrence in the system.

And if I leave you with anything, its China is not going to be able to reduce the problem of counterfeiting and piracy until it makes and—until it makes piracy a true criminal offense. No country in the world has been able to deal significantly with high levels of piracy without using its criminal law.

China has, to date, basically refused to do that. And until they do that, we don't think there's going to be any significant change.

And I just wanted to give you an example of the kind of—of why piracy rates stay at this level despite the fact that you have so much raiding. In fact, China, one agency there seized 115 million optical media discs in 2002, which is the largest in the world, and it's, of course, a drop in the bucket compared to what really passes through the marketplace in China.

But if you take, for example, the drug dealing business, you can make profits there of 100 or 200 percent. But one act of major piracy of, say, Microsoft's Office, the profit can be up to 900 percent in China from just copying that program.

The system is ad hoc. It lacks coordination. Vice Premier Wu Yi has been given the mantle to deal with this problem. We hope she can do it. It's absolutely critical that there be some sort of centralized, coordinated enforcement machinery.

My final remarks deal with market access. In particular, the entertainment industries have been severely limited. I didn't put this in my testimony, because I was unable to confirm it, but just to give you a rough example—and I think this is order of magnitude—the entertainment marketplace in China is estimated to be \$1.5 billion. The legal marketplace is \$65 million. U.S. companies generated last year \$3 million in China. So that gives you an idea of what it's like there.

Thank you very much.

[The statement follows:]

**Prepared Testimony of Eric H. Smith
President, International Intellectual Property Alliance**

Introduction

My name is Eric H. Smith, and I am President of the International Intellectual Property Alliance, or IIPA. I am pleased to have this opportunity to share with you the perspectives of the U.S. creative industries on China's WTO compliance.

About IIPA

IIPA is a coalition of six trade associations¹ representing the copyright industries, which now contribute well over 5% to the total U.S. economy.² IIPA's members produce the nation's books, recorded music, films, videos and TV programming, and computer software for business and entertainment uses. Since 1984, this diverse range of industries has worked together, individually and under the IIPA umbrella, to strengthen the copyright laws and enforcement regimes in over 100 countries around the world. IIPA has also represented the copyright-based industries in the

¹ IIPA's members are: *the Association of American Publishers (AAP)*, *AFMA* (formerly the American Film Marketing Association), *the Business Software Alliance (BSA)*, *Entertainment Software Association (ESA)*, *the Motion Picture Association of America (MPAA)*, and *the Recording Industry Association of America (RIAA)*. IIPA's members represent over 1,100 U.S. companies.

² Economists Inc., *Copyright Industries in the U.S. Economy: the 2002 Report* (2002).

negotiation of key bilateral and multilateral agreements (including of course TRIPS) to raise international minimum standards of copyright protection and, of increasing importance, enforcement.

Specifically with respect to China, IIPA's members were at the forefront of discussions in 1992 that led to the signing of a Memorandum of Understanding between the United States and China. That MOU obliged China to protect copyright in line with international standards in place at the time. IIPA's members were again at the forefront of USTR-led negotiations in 1995 and 1996, resulting in yet another Memorandum of Understanding, Action Plan and exchanges of letters, by which China averted at least \$2 billion in Section 301 trade retaliation by closing down factories producing and exporting massive quantities of pirate optical media product with impunity (causing catastrophic disruption of global markets). In 1996, China committed to commence a nationally coordinated enforcement regime to significantly improve protection for all intellectual property rights. Thereafter, IIPA and its members were deeply involved in a number of sectoral negotiations in connection with China's WTO accession (seeking immediate TRIPS compliance upon accession and improved market access for copyright-based industries) that led to China's entry to the WTO effective December 11, 2001. Our goal was to have each of these milestones result in significant commercial gains for the U.S. copyright industries.

WTO Compliance Issues

We thank the Commission for giving us the opportunity to examine where China stands just over two years after its entry to the WTO with respect to copyright protection and enforcement against piracy, and with respect to barriers to entry to the Chinese market. Our conclusion is that two primary problems have kept China's market largely closed and have prevented copyright owners from benefiting from China's accession to the WTO. The first is copyright piracy, which dominates the local market for copyrighted materials and, as in the 1990s, has become an export problem again.³ The second is a set of continuing market access restrictions which not only prevent the industries we represent from obtaining the commercial rewards that the WTO was intended to bring but also, by limiting the entry of legitimate product, exacerbate piracy and make it even more difficult for China to combat it effectively.

On the issue of piracy and copyright protection generally, we have said repeatedly that China has yet to come into compliance with its TRIPS obligations, particularly in the area of meeting its enforcement commitments under Articles 41 and 61 of the TRIPS Agreement. It also has been slow to meet its otherwise restricted market access commitments. Many of these commitments will come fully into effect on December 11, 2004. My remarks today will focus on these two critical issues and what China needs to do. In closing, I will note some positive developments, particularly regarding the areas of academic journals publishing, and in the growing expertise of the specialized intellectual property panels of the courts in China—two areas which at least offer narrow rays of hope for copyright owners wishing to achieve commercial progress in China.

Piracy and China's Responses in 2003

The market in China remains dominated by piracy. Piracy levels (which reflect the percentage of product sold in a market that is illegal) remained at over 90% or above in 2003 for all copyright industries. For the motion picture industry, for example, despite massive raiding and seizures of pirate product throughout China, the piracy rate actually increased to 95% of the market! Put simply, the Chinese enforcement system has failed to significantly lower piracy levels in any significant way over the last 15 years since it passed a modern Copyright Law, despite this massive raiding and seizure activity. Because TRIPS requires China to provide adequate procedures and effective legal remedies to protect copyright "in practice" (not just in its statutory law), its failure to make any dent in piracy rates establishes, in effect, a *prima facie* case for a violation of its WTO TRIPS commitments. Estimated losses due to piracy of copyrighted materials (excluding entertainment software) in 2002 (we are now awaiting new 2003 numbers) were over \$1.8 billion dollars in 2002. But beyond China's TRIPS commitments, this combination of debilitating levels of piracy and huge economic losses to America's creative industries

³As examples of anecdotal evidence, IIPA knows of one seizure by Hong Kong Customs on June 10, 2003 in which over 5,000 pirated DVDs were seized in a transshipment originating from Fuzhou, China. In another example, on June 6, 2003, Macau Customs intercepted a suspected shipment from China, seizing almost 13,000 optical discs including 3,600 VCDs, 3,200 DVDs and more than 5,000 music CDs.

serves as a tremendous *de facto* barrier to entry into the Chinese market for U.S. firms.

Optical media plants in China, including plants licensed by the government, continue to produce pirate CDs, VCDs and DVDs, and there is now clear evidence that underground pirate producers in China have once again begun exporting product out from China, disrupting market in Asia and Europe. The return of pirate exports is a very disturbing development. Imports of pirate product from other territories in Asia also constitute a significant problem. But primarily, piracy in China is homegrown, with a huge demand for U.S. products and little incentive or ability of U.S. firms, or even Chinese firms—legitimate firms—to meet it.

Internet piracy is an ever-growing phenomenon in China today. An example is the so-called ‘cyber-cafe’.⁴ The legal framework for fighting Internet piracy is still inadequate, but recently the Supreme People’s Court issued new “Interpretations” of the Copyright Law’s application in the Internet environment. We do not yet have these in English. We hope they show an improvement in this critical area. China now has 78 million Internet users—reportedly the second highest in the world. When broadband comes to China, the future for our industries will indeed be grim unless that legal and enforcement infrastructure is repaired.

The Chinese enforcement system is unlike what exists in the rest of the world. China relies on *administrative* fines and actions to deal with piracy. Unfortunately, those fines are virtually always too low to provide a “deterrent to further infringements”—a TRIPS requirement. Under TRIPS, acts of “piracy on a commercial scale” must be subject to criminal remedies. While certain acts of piracy are covered by the Chinese criminal code, it is a fact of life in the Chinese system that piracy simply is not prosecuted as a crime. IIPA members are aware of less than 10 criminal prosecutions directly for commercial piracy in the last few years. While there are criminal prosecutions for operating an “illegal business” and this has included engaging in piracy, true deterrence will only enter the system when the penalties are publicly directed at piracy per se and high enough to deter this very lucrative criminal conduct. The plain fact is that we know of no country that has been able to effectively reduce piracy rates significantly without using the criminal law to do so. Piracy is immensely lucrative. To give an example: Time Europe,⁵ has reported that a drug dealer pays about \$47,000 for a kilo of cocaine, and can sell it on the street for about \$94,000, a 100% profit. But for \$47,000 and with a lot less risk, a pirate can buy or produce 1,500 pirated copies of Microsoft’s Office 2000 Professional and resell them for a profit of 900%! It now costs less than \$0.10 to knock off a pirate VCD or DVD, which then sells at retail for as low as \$0.95—usually more.

Part of the problem with China’s criminal system remains the excessively high thresholds set for bringing criminal actions. The high thresholds translate to difficulties convincing Chinese authorities to prosecute commercial piracy cases under the copyright provisions of the Criminal Law. Because of high thresholds and a lack of prosecutions in practice, it is clear that foreign right holders do not enjoy a WTO-compatible criminal remedy in China. One very recent conviction in Shanghai involving U.S. motion picture product resulted in strict penalties being meted out against several defendants. However, as noted above, this prosecution was brought for commission of a crime other than criminal copyright infringement—‘illegal business operations.’

For foreign right holders, enforcement in 2003 continued to involve, almost totally, administrative actions, chiefly aimed at seizing infringing materials, but such efforts remain largely *ad hoc* and lack coordination. The principal agency in charge of enforcement against piracy of motion pictures on VCD or DVD is the National Anti-Pornography and Piracy Working Group (NAPPWC). In 2002, this agency seized almost 115 million pirate disks, yet the piracy rate in China increased in 2003. For one thing, we do not know what penalties were set for these pirates; the system lacks the kind of transparency necessary to be effective.

In another example, one entertainment software company reports that some Chinese factories engaged in the illegal manufacture of counterfeit entertainment software products have been able to continue their operations even after their premises have been raided and infringing goods seized. In addition, shutting down a factory often does not deter further piracy, since in many instances, the same entity merely

⁴The Chinese government has recently directed greater attention on the activities occurring at Internet cafes. While content blocks (i.e., on pornography, news sites, and the like) have been commonly required in such premises, less attention has been paid to possible infringing uses of copyrighted materials, including illegal uses of pirated entertainment software. IIPA hopes the Internet regulations will address this legal deficiency and ensure that Internet cafes strictly adhere to the copyright law, including ensuring that its customers do not engage in the unauthorized use of copyrighted materials, including entertainment software products.

shifts operations to another location under a different corporate name.⁶ As I have noted, the Chinese government must carry out criminal investigations, focusing on organized criminal operations such as those mentioned, and must initiate prosecutions with deterrent penalties against egregious pirates in order for China to meet its TRIPS enforcement obligations.

Another example comes from the experience of the business software industry, the National Copyright Administration of China has principal responsibility for enforcement but has been very reluctant to run raids and seize infringing software in the area that causes the greatest losses to the software industry, unauthorized use of business software in government and business contexts. In 2003 there was one case which concluded in a fine of \$32,000, which we believe to be the highest fine ever, levied by NCAC for piracy of U.S.-origin software. The company involved then went to civil court and got damages of over 6 times that amount! Fines must be imposed at a level that deters this kind of conduct or there will be no disincentive to stop it. Furthermore, NCAC does not have sufficient resources available to it to make a difference in this area.

Market Access: A Necessary Ingredient to Fight Piracy in China

Providing market access to allow more legitimate product into China is an essential element of an effective anti-piracy strategy in the country. It is significant that China, through its WTO commitments, has agreed to open its market in various ways to different copyright industry sectors. For example, it is noteworthy that China has agreed to open its market to wholesale and retail distribution by foreign book publishers. However, the market opening measures for other sectors, particularly in the audio and audiovisual sectors, are much more restrictive. It is now of paramount importance that the U.S. Government work not only to secure the commitments made through any necessary changes to China's legal system, and to ensure that the gains that were promised are not stymied by continued restrictive commercial practices in China but also that it begin now to urge China to undertake further market opening measures by eliminating existing restrictions.

For example, policies such as China's WTO commitment to allow in a minimum of 20 films annually under standard commercial terms (revenue sharing) essentially provide pirates with a monopoly in the Chinese market for the six-month period between theatrical release of a motion picture and the release of the product in home video formats. If delays are permitted to occur in the censorship process for home video entertainment, then pirates have an even longer period in which they can operate before legitimate product enters the market. For other industries, for example, the book publishing industry, the WTO commits China to gradually open retail (beginning in December 2002) and wholesale distribution to foreign entities (both without restrictions except as to "chain" retail stores no later than December 2004). Unfortunately, continued severe restrictions on activities of paramount importance to U.S. publishers, such as printing (which is "restricted") call into doubt whether China can meet its WTO obligations under the current system.

The record industry faces serious market access hurdles (for every essential activity to their business in China) that result in limiting China's ability to effectively fight piracy. The WTO commitments oblige China to open wholesale and retail distribution to foreign [record] companies in contractual joint ventures with Chinese firms (but not wholly-owned foreign entities).⁷ Other essential activities such as the signing of recording artists, artist management, and producing sound recordings, are left out of WTO commitments. Chinese guidelines make it clear that "publishing, producing, master issuing and importing" of records in China are prohibited foreign investment activities, as is broadcasting,⁸ while distributing and selling

⁶For example, in October 2002 and January 2003, Chinese administrative agencies raided the "Electronic Dragon" production facilities at which over 49,000 counterfeit Game Boy Advance cartridges and components were confiscated. During post-raid surveillance, the company found that the factory had resumed operations in a different location under a new company name. A subsequent raid on the new location was conducted in July 2003 and more than 78,000 counterfeit Game Boy Advance cartridges and semiconductor chips were seized. The principals all fled China and authorities have been able to take no further action against them. Such actions by the pirates and difficulties enforcing against them indicates how well developed and sophisticated these manufacturers and distributors have become. Such organized criminal behavior demands a coordinated national response from the Chinese government.

⁷World Trade Organization, Report of the Working Party on the Accession of China, Addendum, Schedule CLII—The People's Republic of China, Part II—Schedules of Specific Commitments on Services, List of Article II MFN Exemptions, WT/MIN(01)/3/Add.2, Nov. 10, 2001.

⁸The chief piece of legislation governing the record industry in China is the Administrative Regulations on Audio-Visual Products, State Council Order No. 341, Approved December 12, 2001 at the 50th session of the State Council's Standing Committee, signed and promulgated December 25, 2001 by Premier Zhu Rongji, and effective from February 1, 2002).

records is a “restricted” activity. In practice, certain “cooperative” agreements (not joint ventures) may allow foreign entities to publish and produce in China, and there also apparently are no restrictions on a foreign entity signing and managing artists as long as they have proper permits. Nonetheless, the overall restrictive nature of the recording business in China makes it impossible for China to effectively fight piracy of foreign content. More important to the Chinese people and the Chinese economy, failure to open the Chinese market to those with the wherewithal and know-how to make records and distribute them makes it impossible for the vast majority of record producers worldwide to bring local Chinese content to the Chinese people and to make those artists and the music known to the world.

Our government must seek greater market opening measures for all U.S. copyright owners in China, as a necessary step in addressing the problem of piracy in a fundamental way and to make China the meaningful market that it could be.

But There Has Been Some Progress

Despite the many problems and deficiencies in the enforcement system in China, the Chinese government continuously expresses that it is serious about reducing piracy and many government ministers do appear to be sincerely concerned about the problem. Indeed, Chinese government officials have admitted in recent years that piracy is serious, and both the problem and the government’s awareness of it have been reported in the Chinese press.⁹ Periodic crackdowns during 2002 and 2003 have resulted in seizures of tens of millions of pirated products. In addition, between January of 2002 and July of 2003, 18 VCD/DVD factories (2 of which were registered) were raided, yielding seizures of 45 VCD/DVD production lines. Regarding retail raids, the Ministry of Culture has stated that in the same time period, more than 5,000 retail shops were raided nationwide. The seizure numbers indicate both the resolve of Chinese authorities to continue trying to rid the markets of some product but also the sheer magnitude of the problem. Simply stated, it will be impossible for the Chinese government to rid the market of piracy based on periodic anti-piracy campaigns and without a more coordinated, sustained effort, accompanied by deterrent penalties.

An example of real progress involves journal publishing. Through immediate implementation of a State Council Decree issued in late 2001, the pirating of academic journals has been largely diminished. As a result, foreign publishers have been able to negotiate arrangements with customers to legitimately purchase or license use of academic journals. This positive development is an excellent example of how the Chinese government can open a market that was previously closed due to piracy. We sincerely hope that the progress made with regard to academic journals will be mirrored in future efforts to combat piracy of other types of products, both within and outside the field of publishing.

China should also be acknowledged for the continued development of their specialized IPR courts. These courts handling IP cases in China continue to mature in their expertise with copyright issues and appear to be working well in deciding copyright cases.¹⁰ In the most recent cases, relatively large civil damages—in a software case, over \$180,000, were awarded to foreign plaintiffs for infringement of plaintiff’s copyrighted materials, in addition to the court enjoining further infringement and requiring the defendants to issue public apologies and be subject to severe sanctions if they repeated the infringement. We are also pleased to be able to report that foreign copyright owners are generally receiving good cooperation from government and judicial authorities in bringing civil cases. In some instances, foreign right

⁹ See, e.g., Weifeng Liu, *42 Million Discs Smashed in Nationwide Crackdown, Guangdong Key Target in Drive Against Audiovisual Smugglers*, China Daily, August 13, 2003 (in which Gui Xiaofeng, Deputy Director of the Press & Publications Administration and Deputy Commissioner of the National Anti Piracy & Pornography Working Committee said that pirated products have become a big problem for China, adding that the smugglers were not only breaching China’s copyright laws but are also tax evaders); see also *Copyright Law Solid But Needs Fortifying*, China Daily, Sept. 14, 2000, at http://search.chinadaily.com.cn/isearch/i_textinfo.exe?dbname=cndy_printedition&listid=15654&selectword=COPYRIGHT%20PIRACY (quoting then National Copyright Administration Commissioner Yu Youxian as saying that the Copyright Law in China needed amending because “[a]nti-piracy regulations are not strong enough, since piracy was not serious when the law first took effect,” and that “more provisions must be added because piracy has become rampant [in China] today”).

¹⁰ For example, on March 24, 2003, the Shanghai No 2 Intermediate People’s Court ordered three copyright violators to pay a combined 500,000 Yuan (US\$60,241) in compensation to the Shanghai Lexicographical Publishing House for pirating “Cihai,” the most popular encyclopedia in the Chinese language. Some recent cases involved uses of copyrighted works in the digital environment, and were decided in accordance with the laws and with reasoned decisions in writing. See, e.g., *Guangdong Taixin Co Ltd. v. EMI (HK) Group Ltd.*, Guangdong Province People’s High Court Civil Judgment (2001, Guangdong Province People’s High Court IP Case No. 153).

holders are also receiving positive press regarding their actions against alleged infringers. These developments are noted by those on the ground in China as fundamental changes in the legal landscape in China since it joined the WTO.

Conclusion

Despite this progress, and the enormous seizures of pirate product, and periodic “campaigns” by local governments against piracy, the piracy situation in China remains largely unchanged since it joined the WTO—that is, it remains dire. With the timetable for China’s other WTO commitments (as distinguished from its TRIPS commitments which were immediate upon accession to the WTO) drawing close, the time is now for the Chinese government to acknowledge the nexus between practicable market access and the ability to effectively fight piracy. Piracy in China cannot be defeated or effectively deterred by enforcement alone—it must be accompanied by market-opening measures. Some of the necessary steps are reflected in China’s WTO commitments. Others, such as allowing greater distribution of motion pictures in China by foreign companies, or allowing essential activities related to record production or book publishing by foreign companies, have not occurred, but must begin to occur if China is to have any hope of effectively curtailing copyright piracy. The continuous vacuum left by China’s closed market will always be neatly filled by pirates who, by the very nature of their illegal activities, do not adhere to legitimate market rules. The time is now for the U.S. Government to engage with the Chinese government to expand understanding of the nexus between increased market access and effective approaches the enormous piracy problem in China. Again, I wish to thank you for giving IIPA the opportunity to share the copyright industries’ experiences in China, and to chart a road forward to tackle copyright piracy.

Co-Chair REINSCH. Thank you, Mr. Smith.

Ms. Craib, welcome.

STATEMENT OF ANNE CRAIB DIRECTOR OF INTERNATIONAL TRADE AND GOVERNMENT AFFAIRS SEMICONDUCTOR INDUSTRY ASSOCIATION

Ms. CRAIB. Thank you for inviting me to be here today.

If you don’t mind, I’ve submitted my written statement, and I’m going to engage in a little bit of real time editing to try to address some of the questions that you asked previous panelists. I hope you don’t mind. I would also like to say that unfortunately, there was a typo, and I put February 5 of 2003 and I would like to assure the panel, including Mr. Reinsch, who says that we bring the same thing over and over—this is not actually from last year. So I apologize for that confusion.

As an overview to what I’m going to say, SIA was a very strong supporter for China joining the WTO. We were a strong supporter of PNTR. We lobbied hard in Congress to try to help make sure that that passed. Despite the challenges we’re having with China today, we stand by those decisions and would again, if we were to do it over, would still advocate that China belong in the tent rather than outside.

That said, I would like to give you a brief overview of the SIA. We represent about 85 percent of the \$70 billion U.S. semiconductor production sector. As far as we know, we are the only sector to lose market share lead to Japan, which we did in the eighties at a very dark time in our history, and subsequently regain that. Today, we represent—the U.S. industry has over 50 percent world market share, which we’re very proud of.

It’s a global industry. The vast majority of U.S. company production is done in the United States. The vast majority of our high-value-added manufacturing and jobs are in the United States, and while we fully support that it’s a global industry, because the information technology sector is global, our goal, really, is to keep the

bulk of leading edge manufacturing in the United States. That's something that I know you all are interested in as well.

We believe that that's important for a number of reasons, including the fact that we are the building blocks for the larger IT industry, but also, if you look at the semiconductor industry, it's really kind of an ecosystem. A big part of that ecosystem consists of things like university research, and we feel very strongly that that is a crown jewel of the U.S. is a strong university research system that has great competency in microelectronics.

It would be hard to imagine losing leading edge manufacturing in semiconductors and maintaining that R&D capability in our universities, because frankly, in order to get students to go study it, you have to have jobs for them when they are done, and so, we do think that that's part of the entire package.

For semiconductor manufacturing, design, obviously is labor-intensive. It's a lot of very, very intelligence people, but manufacturing is not labor intensive. And so, the differential labor rates in various parts of the world don't really have a tremendous impact on where we choose to locate manufacturing facilities.

We commissioned a fairly lengthy study that I would be happy to share with you. I didn't know how many pounds of reading material you wanted, so I haven't brought it here today, but we did commission a lengthy study that shows that the difference in manufacturing costs between China and Taiwan is somewhere on the order of maximum 4 percent.

Now, if you take the 4 percent cost differential and then factor in some logistical challenges that come with locating in China, where your infrastructure isn't as well developed versus Taiwan, it's not a significant factor in making a difference for semiconductor manufacturing. And again, I'd be happy to provide copies of that study to each of you if you'd like it.

We believe that the Chinese market is a very compelling one. They're the most rapidly growing market in the world today. They're the second largest or approaching the second largest market for semiconductors. If you look at specific sectors, they're the largest cell phone market in the world. We have estimates that indicate that about 8 percent of total electronic production right now, world electronic production comes out of China.

We are an input into that production, and so, we need to be able to access a market where level of electronics manufacturing is going on.

There are three key issues where we have WTO compliance problems: the value added tax, which you have heard about a lot discussed today; basically, 17 percent on all products. If you manufacture in China, you get 14 of that 17 back. Our view and that of USTR, as you heard this morning, is that that is a clear violation of Article III of the GATT on national treatment. I would be happy to go into more depth on that if you'd like me to.

We don't believe that this policy actually benefits China much, because, if, again, you look at something like a cell phone, what they're doing is making their companies less competitive by raising the costs of components that go into cell phones. The rationale behind the policy is to force you to manufacture leading-edge semiconductors in China.

Frankly, it's working. There is an unprecedented amount of investment going into China right now. We don't think it can be fully commercially justified and in fact have talked to a number of those investors who say flat out they made the decision to invest because they had to get around the 14 percent VAT differential.

We would like very much to be able to supply the China market from here in the United States. If this VAT policy remains in place, that's going to be difficult if not impossible. In an industry where a fraction of a percent typically makes the difference between making a sale or not, 14 percent is just something you can't overcome.

In terms of the timing of a case, there was again some discussion of that this morning, and if you look at the way cases move through the WTO, I think an optimistic estimate from the day that you file a case until you have resolution, and we do think resolution would be in our favor, and the policy has changed, it's 30 to 39 months.

That's a very long time, and frankly, we have worked very closely with the USTR to try to see if we can't resolve this diplomatically, because once you file the case, the chance that there will be a solution before that 30 to 39 months has run its course is virtually nil, and this is a time sensitive issue. The level of investment is unprecedented, and if it all actually gets built, there will be severe overcapacity in our industry, but also, the bulk of leading edge manufacturing will be in China. That will drive equipment purchases and any number of other things.

Very quickly, we think PR is linked to this. Many of our companies have PR problems in China, and if you look at the number of fabs that are being built and the amount of capacity that's going to be coming on line and couple that with a not perfect respect for intellectual property, you're going to have some really serious problems when these factories have to figure out what to make, and many of them will manufacture any design that is brought through the door, whether it's owned by a foreign company or the person bringing it to them.

Lastly, I would like to raise an issue that we do feel is a WTO violation but I don't know is ripe for a case again because of timing and that's the wireless LAN issue. China, in December, implemented standards that apply to wi-fi products. And it's a proprietary Chinese standard. It has been given to 24 Chinese companies. In order to sell wireless products into China, you are going to be forced to coproduce with one of these 24 companies.

In order to do that, you have to give them the design to your product so that they can integrate the encryption technology into the semiconductor. We find this very troubling. We do think that it would be a winnable WTO case; however, the implementation date is June of this year. There's not time to go through a 30 to 39 month process to address that. We are supporting USTR in addressing this issue.

I'll leave it there.

[The statement follows:]

**Prepared Testimony of Anne Craib
Director, International Trade and Government Affairs
Semiconductor Industry Association**

Hearing on China's WTO Compliance and U.S. Monitoring Efforts

The Semiconductor Industry Association (SIA) represents the \$70 billion U.S. semiconductor industry. SIA member companies comprise approximately 85% of U.S.-based semiconductor production. Collectively, the chip industry employs a domestic workforce of 255,000 people. U.S. semiconductor firms are leading global competitors, commanding a 50 percent world market share.

Semiconductors are the building blocks for American competitiveness in a broad range of high technology goods—from computers to medical technology. A strong and vibrant semiconductor manufacturing industry is a key part of a healthy information technology ecosystem—it supports everything from research and development to a robust university capability in microelectronics. U.S. semiconductor makers have facilities around the world, as needed to serve the global IT industry. While such a global span is necessary to remain competitive, the members of SIA also believe it is vital to retain leading edge manufacturing capabilities here in the United States—our policy objectives are aimed at supporting that goal.

Today, China is the third largest country market in the world today for semiconductors, and enjoys the world's highest growth rate. By 2010, China is predicted to be the world's second largest country market for semiconductors, behind only the United States. Semiconductors are the second largest U.S. export to China and China's number one import. China can and should have a major role in the global semiconductor market—however, we believe that China must build these capabilities based on fair, transparent and WTO-consistent policies.

Over the past decade, SIA was a strong supporter of China's accession into the World Trade Organization (WTO) and of legislation to provide Permanent Normal Trade Relations for trade with China. We are also pleased that the Chinese government has taken a number of positive steps in implementing its WTO obligations. China signed the Information Technology Agreement (ITA), and eliminated tariffs on a range of information technology products when it joined the WTO—this was a very positive step not only for those selling into China, but for China's own economic development. SIA has long supported the elimination of semiconductor tariffs, beginning with the suspension of U.S. tariffs in 1985, because tariffs increase the costs to consumers of not only semiconductors but also finished information technology products. The spread of IT products fuels benefits in the economy.

Despite progress in some areas, the Chinese government needs to take additional steps to fulfill the commitments it made under WTO accession. My testimony will focus on those issues of special relevance to American semiconductor producers, including China's value-added tax (VAT) rebate for domestically produced chips, unique standards development, and inadequate intellectual property protection.

VAT Rebate

China imposes a VAT of 17% on sales of all imported and domestically-produced semiconductors and integrated circuits. However, current Chinese government policy provides for a rebate of the VAT burden in excess of 3% for certain integrated circuits manufactured within China.¹ **This discrimination against imported semiconductors through the VAT rebate is inconsistent with China's WTO obligations.**

GATT Article III (on "National Treatment") states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. By rebating the amount of the VAT burden over 3% for local products, while continuing to impose the full 17% VAT on imported semiconductors, the current policy violates this most basic GATT/WTO obligation.

The semiconductor industry is a tremendously competitive business—a fraction of a percent can make the difference in winning or losing a sale. A 14% differential created through WTO inconsistent tax policy is a burden that foreign companies simply can't overcome in selling into the Chinese market.

In addition to market access concerns, the VAT policy is severely skewing investment patterns. China's IC industry attracted \$3.6 billion of new investment from 2000 to 2002, with investment projected to reach \$12 billion by 2005 and \$25 billion by 2013. This is an unprecedented amount of investment that cannot be justified on commercial terms and is likely to lead to severe overcapacity in the industry in

¹The Chinese government has not released the encryption algorithm, the interface for the encryption, nor the testing requirements.

future years. We have done quite a bit of research in this area, and it is clear that the VAT rebate is a major factor in these investment decisions. This investment flow makes the VAT a very time-sensitive issue—if the problem is not solved and all slated investments are made, the bulk of cutting edge capacity will be in China.

We are not alone in finding this policy quite alarming. The World Semiconductor Council (WSC), representing industry from the U.S., Europe, Japan, Korea, and Taiwan, condemned China's VAT rebate policy in the following joint statement issued in May 2003:

Discrimination [due to the VAT policy] has the effect of limiting market access, distorting patterns of trade and investment, and negates the benefits China promised to provide when it joined the WTO. The WSC calls for China to lower its VAT rate to 3% for all semiconductors, regardless of origin.

SIA continues to work with our counterpart associations in Europe, Japan, Korea, and Taiwan on this issue.

The same public policy reasons that caused China to decide to join the ITA and eliminate its tariffs on semiconductors apply with equal force to a decision to lower the VAT rate—raising the cost of access to information technology harms economic development. A substantial portion of the growth of the American economy has been attributed to information technology and the productivity enhancements made possible by advances in semiconductor technology and production. Just as it was in China's interest to eliminate all import tariffs on semiconductors, significant reduction in the VAT rate imposed on all semiconductors would contribute to the growth of the Chinese IT market and would benefit the Chinese economy in general. In addition, reports indicate that China's elimination of semiconductor tariffs (formerly 6-12%) has succeeded in reducing smuggling of semiconductors into China. As the high VAT rate on semiconductors provides an incentive for smuggling, this runs counter to the high priority the Chinese government has placed on eliminating illegal entry of goods.

We have worked closely with USTR, Commerce and others in the U.S. Government to try to seek a solution to the VAT issue. Last summer, the Chinese government gave indications that it was willing to explore the WTO implications of the VAT rebate policy, and a working group reportedly was formed to examine the issue. However, SIA is disappointed that recent discussions with the Chinese government demonstrate a lack of flexibility in bringing this policy into compliance with WTO rules.

The best solution for U.S. export interests and the development of China's information technology market is for China to reduce the VAT rate to a level of 3% or eliminate the VAT for all semiconductors and integrated circuits, regardless of origin. Clearly, a diplomatic solution to this issue would be preferable for all parties involved. However, the time sensitive nature of the problem dictates that a solution must be found sooner rather than later, and if we expect to retain a competitive industry here in the U.S. we must resolve this issue soon. If the issue cannot be resolved through diplomatic means, we believe USTR will have no recourse but to file a WTO case—we stand ready to fully support that effort if and when USTR makes such a decision.

Standards

SIA notes with concern an increasing use of unique national standards in China that are designed to favor domestic suppliers. The wireless LAN issue is one vivid example. In May 2003, China issued two new WLAN standards (that define a requirement to use Chinese encryption technology) which the Chinese government said were needed for national security reasons. However, established international efforts exist through the Institute of Electrical and Electronics Engineers (IEEE) to address multilevel security schemes for wireless networks. The new Chinese standards differ significantly from and are incompatible with internationally-recognized protocols, and would require creation or adaptation of products solely for the Chinese market. Country unique standards won't benefit China in the long run. New technology standards evolve rapidly and are continuously improved and modified by international standards groups and as a result of innovations of thousands of companies. The losers are proprietary technologies that attempt to compete with the global standard—however, ultimately they cannot compete with the cost/benefit that a successful global standard delivers. Moreover, proprietary standards that are not widely adopted can lead to problems with product interoperability. In fact, past experiences illustrate that proprietary standards often become obsolete in fast paced global industry, leaving those who adopted them to fall behind or simply go out of business.

This requirement would affect a range of technology products with wireless LAN capability, including chips, wireless cards, computers, printers, and scanners.

The standards became effective on December 1, 2003, even though the technical details for implementation of the Chinese requirements are still not readily available to non-Chinese companies.² Through extensive U.S. industry effort and bilateral discussions led by the U.S. Department of Commerce, USTR, and the State Department, a six-month grace period was enacted—through June 2004. Reports now indicate that Chinese authorities will require foreign firms to engage in value-added production with a select list of 24 local firms to obtain import permits in order to sell wireless LAN equipment in China. Products already in-country will also be required to obtain permits. The so-called co-production requirement will require U.S. and other foreign companies to share an unprecedented amount of intellectual property with—in effect—their Chinese competitors. Those competitors will also be responsible for certifying whether or not foreign companies are compliant with the standard before they can sell in China.

If enforced, such requirements would set a dangerous precedent by imposing technology transfer and local content requirements that China committed to eliminate with WTO accession.³ The issue remains active, and SIA appreciates the continued efforts of the U.S. Government to encourage China to adopt internationally-recognized standards.

We will work with USTR to carefully monitor China's standards development in the electronics area to ensure it is not used as an industrial policy tool to foster China's information technology production goals by creating market access barriers. China committed to abide by the WTO's Technical Barriers to Trade (TBT) Agreement, including publication of notices of adopted and proposed technical regulations, standards, and conformity assessment procedures.⁴ **China must notify standards development activities that affect imports to the WTO's TBT committee as early in the process as possible.**

If these types of practices continue, they will have a real and significant negative impact on U.S. electronics firms, to the detriment of U.S. economic interests. Moreover, such forced cooperation measures have a negative effect on China, as they discourage the investment necessary to develop a local Chinese electronics industry on a commercially-sound basis.

Intellectual Property Protection

SIA would like to underscore the importance of China's full compliance with its commitments to improve intellectual property (IP) protection. Adequate IP protection is critical not only to U.S. firms doing business in China, but is also in China's self-interest, as it will encourage the high technology foreign investment China seeks in order to promote the development of its economy, while simultaneously encouraging local entrepreneurs to engage in innovation.

Accession to the WTO required China to enact specific legislation **to extend intellectual property protection to semiconductor layout designs** (maskworks) consistent with TRIPS. On March 28, 2001, China's State Council passed the *Regulation on Integrated Circuit Layout Design Protection* as part of its preparations to join the WTO. The regulation took effect October 1, 2001. This legislation also covers discrete semiconductors, as confirmed to the WTO by the State Intellectual Property Office (SIPO).

Intellectual property protection is of great importance to U.S. semiconductor producers, as China's capabilities in the semiconductor sector are rapidly advancing. The intellectual property contained in the design of a maskwork remains one of the highest value-added components of chip manufacturing. SIA is aware of at least two cases where maskwork violations have occurred in China.

In addition to observing the TRIPS obligations, China should take steps to strengthen **trademark enforcement**. While Chinese intellectual property laws are generally sound, and Chinese administrative agencies have been cooperative in taking action against trademark counterfeiters, trademark protection laws could nonetheless be improved. China should also strengthen its judicial system to ensure consistent and effective **patent enforcement**. Courts have not had much experience in highly technical cases, such as semiconductor or electronics patent cases. Finally,

²State Council Document Number 18, June 2000; State Council Document Number 70, December 2002

³"China shall ensure that the distribution of import licenses. . . or other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in China." China's WTO Accession Protocol, *Non-Tariff Measures* P.I.7.3.

⁴China's WTO Accession Protocol, *Technical Barriers to Trade* P.I.13.2, and China's Accession Working Party Report IV.D.3.177

general transparency in the courts should be improved so that all cases (including patent cases) are handled openly and fairly.

Given the short life-cycle of products in the semiconductor industry, illegitimate products can severely damage a U.S. firm's ability to reap the legitimate results of its intellectual and capital investment. SIA has discussed with USTR the idea of a "fast-track" mechanism to address IPR violations in an expedited manner. In addition, the World Semiconductor Council is developing a code of conduct for producers, which China would benefit from once it becomes a WSC member.

Conclusion

China is growing into a major force in the information technology arena—both as a customer and as a competitor. Given the size, growth, and potential of the Chinese market, it is essential that U.S. semiconductor firms have the chance to compete fairly. China has made notable progress with respect to its WTO commitments, but its government must make additional efforts to bring all policies into full compliance. The elimination of the discriminatory value-added tax, increased use of international standards, and improved protection of intellectual property are key areas where SIA will continue working with USTR, Commerce, and State to insist on fulfillment of China's WTO commitments. I must stress that these issues are time sensitive—they must be resolved in a short period or the damage to the U.S. industry could be considerable. SIA appreciates the opportunity to appear before the Commission today to testify on these important issues.

Co-Chair REINSCH. Thank you very much.

Ms. Wroblewski, welcome.

STATEMENT OF ANN WROBLESKI INTERNATIONAL VICE PRESIDENT, AMERICAN FOREST AND PAPER ASSOCIATION

Ms. WROBLESKI. Thank you, Mr. Chairman and members of the Commission.

I am Ann Wroblewski, Vice-President of International at the American Forest and Paper Association, and I appreciate this opportunity to speak with you this afternoon.

The American Forest and Paper Association is the national trade association of the forest, pulp, paper, paperboard and wood products industry. The more than 200 companies and related associations AF&PA represents have a strong interest in making sure that China meets its commitments it made as a condition of its accession to the WTO.

Given the sheer volume of those commitments, AF&PA recognizes that full compliance will not be achieved overnight. We appreciate the U.S. Government's efforts to ensure that China establishes sound foundations for an open market economy and that any missteps or questionable practices under WTO rules are corrected immediately.

China's domestic forest products industry faces a large fiber resource supply shortfall due to insufficient domestic forests and growth in demand for wood, pulp and paper. Nonetheless, China is rapidly developing a large domestic industry. In doing so, China is employing an array of questionable practices, which substantially reduce market opportunities for our manufacturers.

Let me just mention four such practices. First, they are providing subsidies such as low interest loans, interest rate forgiveness, extended repayment terms and preferential tax policies, which encourage greater domestic production. They are using their tariff structure to encourage imports of raw materials—in our business that would be logs, wood pulp, recovered paper—versus finished products. Third, they're protecting domestic producers through non-tariff barriers, product standards and increasing use of anti-

dumping investigations. And fourth, they are expanding border trade VAT provisions to allow for large increases in low cost wood imports from neighboring countries, specifically Russia.

Under its WTO accession agreement, China committed to significantly reduce its tariffs on wood or paper products. However, China has largely nullified this commitment by engaging in protracted, large-scale intervention in foreign exchange markets in order to keep its currency weaker than it would be if based on market forces alone.

The undervalued Chinese currency has undermined our industry's ability to compete in that market. It has made the Chinese foreign products industry artificially competitive and an attractive sector for targeted government financing, resulting in a substantial buildup of Chinese production capacity. The outcome is predictable: huge increases in imports from China and a loss of export opportunities for the American industry.

For example, U.S. imports of paper and paperboard products from China jumped to an estimated \$1.05 billion last year. In contrast, U.S. paper and paperboard exports were an estimated \$425 million. China has also become a large net exporter of wood products. Further, the large foreign exchange reserves accumulated by China serves as a ready supply of cheap money, money that's being channeled through state-controlled banking systems to build capacity, including large state-of-the-art pulp, paper and wood processing mills.

GATT Article 15, as Mr. Primosch said, stipulates that members should not take exchange rate actions, which, quote, frustrate the intent of the provisions of the agreement, namely, negotiated reductions of tariffs and other barriers to trade. For this reason, we believe that USTR should assess how exchange rates impact market access in China, and the U.S. Treasury and USTR should engage the Chinese in consultations on this topic.

On tariffs, China's WTO accession agreement included commitments to reduce most paper and wood tariffs to 5 to 7.5 percent. However, the U.S. industry has faced inconsistent application of tariffs on wood products. These inconsistencies effectively create an unfair tariff barrier. Additionally, nontariff barriers in China, including restrictive codes and standards, inconsistent customs procedures and other illegal and counterfeiting activity severely hinder trade and erode the benefits of the tariff elimination.

AF&PA is currently exploring negotiating opportunities in the WTO round that would lead to the elimination of targeted nontariff barriers in our sector. This represents a real opportunity for meaningful progress. China, as one of the top consumers of forest products, needs to be a key participant in this process.

In the meantime, however, AF&PA would like to highlight two other areas of concern. We have reports that Chinese value added tax has not been applied equally to domestic producers and to all imports. Moreover, in some Chinese jurisdictions, VAT is not applied at all to domestic producers, giving them a competitive advantage.

The U.S. and China's other WTO partners must ensure that Chinese authorities establish a uniform, nondiscriminatory method for collecting and reporting the collection of the VAT. Also of concern

to our industry is the amount of illegally harvested timber that is believed to be entering the China market, particularly from the border areas of Myanmar and Russia.

Illegal logging undermines public acceptance of legally harvested and traded forest products. U.S. trade opportunities in China are directly affected by the abundance of inexpensive, illegally harvested timber flowing into China. Progress is being made, but concern still exists over the presence of this illegally logged wood in the marketplace.

In conclusion, AF&PA believes the Chinese market offers enormous potential for future exports of U.S. wood and paper products. We expect these new market opportunities to be hotly contested by both domestic and other foreign suppliers. To ensure that the U.S. industry has a fair chance to compete in the Chinese market, AF&PA strongly supports comprehensive compliance efforts by the U.S. Government.

Again, I appreciate this opportunity to provide comments on these issues, and I look forward to answering any questions you might have. Thank you.

[The statement follows:]

**Prepared Statement of Ann B. Wroblewski
Vice President, International American Forest and Paper Association**

The American Forest & Paper Association (AF&PA) appreciates this opportunity to present the forest and paper products industry's views regarding China's compliance with WTO accession commitments.

Given the numerous commitments required of China during the negotiation process, AF&PA recognizes that full compliance will not be achieved overnight. We strongly support the U.S. Government's effort to closely monitor China's actions as it undergoes this massive transition process to ensure that sound foundations for an open market economy are established and that any missteps or questionable practices under WTO rules are corrected immediately.

AF&PA supported the Congressional grant of permanent normal trading rights to China. This policy was driven by the expectation that our country's abundant fiber resources, skilled labor force and access to capital provide the U.S. forest and paper industry with the comparative advantage to compete in the global marketplace. In fact, a decade or so ago, the Chinese market looked like an extremely attractive export opportunity for U.S. forest products for many years to come. This was a common view shared not only by industry executives, but also by other expert observers and Wall Street analysts. Why? China does not have substantial forestlands, their domestic demand was on the verge of a major growth spurt, and their manufacturing facilities were small and inefficient and not able to meet environmental standards. Paper and wood products manufacturing are capital intensive—not labor intensive—so China shouldn't possess a natural comparative advantage in the paper and wood sectors.

However, this ostensible comparative advantage of the U.S. forest and paper industry has been undermined by China's unfair exchange rate policies, direct and indirect subsidies to support massive expansion of China's paper and wood processing industries, non-tariff barriers and other government practices that have served to nullify China's WTO accession commitments.

Subsidies

A key element in the growth of China's forest products processing enterprises has been direct and indirect subsidies that have been granted to the industry for capacity expansions and technology improvements. Billions of dollars of loan interest forgiveness, extended repayment terms, and lower than market interest rates have been granted to domestic and foreign enterprises to encourage greater production in China. Loans to the forest products sector are provided by both large state-owned or state-controlled banks, with the loan interest subsidy underwritten by the Chinese government. Furthermore, the range of subsidies begins at the fiber raw material production level, and extends throughout the production chain. Many of the

measures used to achieve this rapid industry development include subsidy measures that may not be WTO-legal.

The effect of these policies has been to encourage large-scale investment in the sector to the extent that in a number of product sectors, significant production overcapacity exists. For example, between 1998 and 2002, the Ministry of Finance used US\$1.67 billion in loan interest subsidies to make technology renovations at 21 state-owned paper manufacturing projects across China.

Since many of the companies that benefit from these subsidies are involved in international trade, either as exporters or as competitors with U.S. suppliers, they have an unfair competitive advantage against U.S. companies which must rely on private funding at market rates.

Currency Manipulation

Under its WTO accession agreement, China committed to open up its market by reducing its tariffs and non-tariff barriers, including those on forest and paper products. However, China has largely nullified this commitment by engaging in protracted large-scale purchases of foreign exchange in order to keep its currency, the Yuan, significantly weaker than it would be otherwise based on international market forces alone. Some economists put the undervaluation of the Yuan at 40 percent.

The undervalued Chinese currency has significantly undermined our industry's ability to compete in the Chinese market and has made the Chinese forest products industry artificially competitive and a very attractive sector for targeted government financing. As a result, the Chinese paper and wood processing sector has experienced a substantial build up in capacity to the point that Chinese forest products are penetrating the U.S. and third country markets. So, while U.S. paper and paperboard exports to China rose by 50 percent from 1997 to \$384 million in 2002, imports from China jumped by almost 160 percent to \$806 million in 2002 and reached an estimated \$1.05 billion in 2003. The U.S. trade balance with China in paper and paperboard products stood at a negative \$422 million in 2002 and jumped to an estimated \$625 million last year in a sector where China doesn't have a comparative advantage. Likewise, China has become a major producer of wood products. Just a few years ago, for example, China imported approximately 2.5 million cubic meters of plywood—today it is a net exporter of approximately 1.7 million cubic meters and now exports large quantities of product to South Korea, Japan and the United Kingdom—all markets that U.S. plywood producers were previously able to serve.

Government manipulation of exchange rates in order to gain a competitive advantage for local industry can substantially offset the balance of benefits U.S. trade negotiators achieve in any trade agreement. The General Agreement on Tariffs and Trade (GATT) Article XV, now incorporated within the WTO, addresses Exchange Arrangements and stipulates that members should not take exchange rate actions which "frustrate the intent of the provisions of this Agreement", namely, negotiated reduction of tariffs and other barriers to trade. For this reason, AF&PA believes that USTR should conduct an assessment of exchange rates impacts on market access opportunities in the Chinese market and, together with The U.S. Treasury Department, engage the Chinese in consultations on this subject.

Tariffs

China's accession agreement included commitments to reduce most paper and wood tariffs to the 5–7.5% level. Most of these rates will be achieved in 2004. However, the U.S. industry has faced the inconsistent application of tariffs on wood products, including the varied classifications for veneer. U.S. veneer exporters have found that they are required to declare that their products are "decorative" and thus face an 8% tariff, while Chinese importers can declare a similar product is "veneer for plywood" and are subject to only a 3% tariff. Other companies report that their customers are paying higher tariff rates than those listed as the current rates.

This discriminatory application of tariffs on some products, and the inconsistent application of tariffs from port to port, further exacerbates the unpredictable nature of China trade. The inconsistent application of policies, the arbitrary assessment of customs duties, and the impunity with which Chinese customs officials act, effectively create trade barriers and undermine Central Government efforts to implement WTO requirements on the working level.

Application of VAT

The Chinese Value Added Tax (VAT) has not been applied equally to domestic products and to all imports. Forest product imports from neighboring countries, but especially Russia, have been subject to only half of the 17% VAT rate (13% VAT on logs.) This "special deal" is not consistent with WTO provisions, and was supposed to have been eliminated upon China's accession to the WTO. On June 1, 2003, the Chinese government removed preferential tax treatment applied to wood pulp

and other pulp, newsprint and certain uncoated groundwood paper. However, logs and timber imports, which account for nearly 90% of Russia's forest products exports to China, still continue to benefit from preferential VAT treatment to the detriment of U.S. suppliers.

China is taking further steps within its VAT regime to promote domestic processing enterprises. Wood processing enterprises using so-called 'non-saleable' wood (primarily small diameter and fast growing species used in particleboard, fiberboard and some plywood) are exempt from VAT payments (13%). These measures significantly disadvantage imported product, as their full VAT assessment must still be paid.

Moreover, in some Chinese jurisdictions, VAT is not applied rigorously to domestic producers, giving them a competitive advantage. The U.S., and China's other WTO partners, must press Chinese authorities to establish a uniform, nondiscriminatory and transparent method for collecting and reporting the collection of the VAT.

Illegal Logging/Smuggling

Of growing concern is the amount of illegally harvested timber that is entering the China market. International environmental agencies have documented significant discrepancies between China's import statistics and the export statistics of some of China's wood trading partners, particularly in border areas with Myanmar and Russia. Illegal logging affects not just the health of the forest in particularly sensitive regions, but also undermines public acceptance of commerce in legally harvested and traded forest products. U.S. trade opportunities in China are directly affected by the abundance of inexpensive, illegally harvested timber.

Compounding the problem is that illegally logged wood is frequently smuggled into mainland China in an effort to avoid the 17% VAT, or is sent to a third country where it is processed and then re-exported to China. The smuggling activity is putting U.S. exporters at a competitive price disadvantage. Progress is being made in shutting down smuggling operations, but concern still exists over the presence of illegally logged wood in the marketplace.

Restrictive Codes and Standards

The U.S. has been successful in having China adopt U.S. design values and grading rules for common species of U.S. softwood dimension lumber into the newly released GB50005-2003 (design code) and GB50206-2002 (construction code), but as yet there is no requirement in either code regarding materials quality conformance, such as requirements for grade-stamps for dimension lumber and wood-based structural panels. This could potentially create quality problems for these wood products.

Currently, China is developing product standards for dimension lumber, wood-based structural panels, engineered wood products and fasteners. In some cases, local builders use non-structural plywood as sheathing or floor material. Even though progress has been made in the area of revising China's Timber Codes to incorporate U.S. design values, grading rules and species, more work is needed regarding the development of product standards and product certification inspection infrastructure to ensure Chinese engineers, inspectors and consumers can determine the quality of structural material. The absence of a formal recognition of U.S. certification agencies, for example, may lead to an increase in the counterfeiting of building materials, or misleading labels being placed on products, which has already been evidenced in the Chinese marketplace.

Counterfeit Trademarking Activity

U.S. industry has also been alerted to the illegal use of U.S.-licensed trademarks on Chinese manufactured structural wood-based panels. This action undermines the integrity of our U.S. accredited quality assurance agencies, U.S. product standards and the potentially successful introduction of structurally sound wood frame construction options into the Chinese market.

Substantial anecdotal evidence also exists indicating that native Chinese wood is being repackaged and sold under the guise of being of U.S. origin but at a much lower cost thus making true American products uncompetitive. This is resulting in serious quality issues with Chinese buyers and could damage the long-term efforts of the industry to educate the Chinese about high quality U.S. wood products. If left unchecked, this could result in serious long-term damage to the perception of U.S. product quality.

Competing Materials/Product Substitution Policies

The U.S. also faces competition from domestic materials that are being promoted as alternatives to timber, such as bamboo, and from steel which is promoted by the Government of China as an alternative construction material.

Under the 1992 U.S.-China Memorandum of Understanding (MOU), China confirmed that policies related to the conservation of domestic wood products would not apply to imported wood products. However, in practice, this anti-wood policy, which required the use of steel, cement and plastic in construction applications, shifted long-term demand for wood down. In fact, for industrial applications utilizing wood (railroad ties, mine support beams, concrete forms, telephone poles), the Chinese have already substituted non-wood products. While there is debate whether this policy is still in effect, it remains on the books and imported wood products may continue to be discriminated against in domestic building projects.

Conformity Assessment

In 2002, China reorganized its regulatory bodies for standards development and conformity assessment into a new Ministry: the State General Administration for Quality Supervision and Inspection and Quarantine (AQSIQ). Concurrently, under China's new role as a member of the WTO, they are also modifying their internal procedures to provide for greater transparency and foreign participation. China requires testing on many regulated products imported into their market and conformity assessment is recognized through the placement of the Chinese Compulsory Certificate (CCC) mark on the material.

There are several concerns from the U.S. regarding the placement of this CCC mark on wood products manufactured in the U.S. First, we would like to see an end to the requirement for in-country testing by a Chinese laboratory. An accredited U.S. laboratory should be able to evaluate U.S. manufactured material to Chinese standards. Duplicate testing in China should not be required for qualification or upon arrival in China. Secondly, a U.S.-based certification organization should be recognized to oversee the application of CCC trademarks on U.S. manufactured goods prior to their shipment to China. This would prevent the need for re-inspection upon their arrival in China. Finally, the time frame for development of a procedure for recognizing foreign certification bodies should be established as soon as possible.

Legal Risk

The business climate in China is characterized by a high degree of regulatory risk; that is, the risk of loss arising from sudden changes in law, policy, or individuals in office. On the one hand, the rapid development of the legal system, a high rate of economic growth, and social change are welcome. On the other hand, the government is forced to respond quickly to changing situations. It often does so pragmatically, to deal with short-term needs, and without coordination among different agencies and levels of government. For most U.S. companies, the lack of nationwide consistency and the varying characteristics of local markets are severe constraints.

With this rapid change, and efforts by the Central Government to reform China's laws to adhere to WTO regulations, the dichotomy between national laws and local enforcement is often significant. Customs officials are often a law unto themselves, and tax collection and enforcement can be arbitrary. In many local jurisdictions, local relationships can cause officials to ignore relevant regulations, including banking regulations where loans are given to insolvent enterprises under the instructions of local officials.

Licensing Requirements

China has loosened import licensing requirements by abolishing the foreign trade qualification approval system, replacing it with another approval system that opens the foreign trade realm to enterprises of any ownership structure. In addition, China is also gradually establishing rights that will allow foreign trading companies to operate in China. China has made specific commitments in this regard, and we would urge the U.S. to ensure China follows through on its implementation timetable and enforces its commitments. Enforcement is essential to ensure that provincial practices do not frustrate the intent of national legal and Central Government policy changes.

Permit Requirements

Duty-free importation is usually associated with either export processing enterprises or a specific economic free zone where duty free import permits are required to import into these zones. The Chinese government will be abolishing the special duty free importation provisions for export oriented processing ventures, as well as special economic zones, as required under WTO obligations, but this process needs to be accelerated. There is also the question of enforcement and implementation of these new regulations at the local level.

Distribution System

There is no integrated distribution system in China as a result of prior laws restricting foreign participation in this sector, provincial protectionism, and underinvestment by domestic enterprises. As part of its WTO accession requirements, China set forth a specific timetable for liberalization of foreign ownership provisions in its logistics and distribution industry, so that by 2005 100% foreign-owned ventures will be allowed in this sector.

Besides weakening the links in the supply chain, distribution restrictions prevent direct access to the customer. This forced separation of manufacturer or importer from customer stifles the consumer feedback that is critical to world-class business operations. One issue, in particular, is the domination of domestic wood distribution networks by Fujianese traders: again, pointing to the problem that despite what the laws and Central Government say, enforcement on local levels is sometimes lacking.

Constraints on the supplier-customer relationship can restrict market access just as protective tariffs do. It is imperative that China follow through on its WTO accession promises and adhere to its timetable to open up this sector.

Phytosanitary Regulations

The Chinese government requires that all imports of logs be certified as pest-free. Logs with bark require special treatment, including a certificate detailing the method of treatment, including chemicals, temperature and time of treatment. Any logs without pest-free certificates or logs with bark that have not received special treatment will not be allowed to enter the country. If quarantine pests are found in logs, treatment will be undertaken at the importer's expense.

As a result, U.S. log exporters have incurred increased expenses due to the high costs of the treatment. Meanwhile, in the case of Chinese log imports from Russia and South East Asia, which are transported via land transportation, the certification requirements are not as strict. The ability for the Chinese government to monitor and enforce requirements on trade over its remote border areas cannot match that of its port facilities.

Conclusion

The China market offers enormous potential for increased future exports of U.S. wood and paper products. At the same time, because of the explosive rate of demand growth in China, and proximity to regional producers, we expect these new market opportunities to be hotly contested by both domestic and other foreign suppliers. To ensure that our industry has a fair chance to compete in the Chinese market, we strongly support comprehensive compliance efforts by the U.S. Government regarding the array of practices that limit market opportunities for American companies, including subsidies, an undervalued currency and non-tariff barriers to trade.

We appreciate the opportunity to provide comments on this issue. Please do not hesitate to contact us for further guidance or information regarding this submission.

Panel IV—Discussion, Questions and Answers

Co-Chair REINSCH. Thank you.

Well done on the part of all of you. This time, we will begin on this side over here with Commissioner Wortzel.

Commissioner WORTZEL. Thank you very much for the testimony.

I recently had the privilege of watching the U.S. Army's Stryker Brigade, the new brigade that features total awareness of the battlefield undergo its final testing. And almost all its computers were off the shelf; almost all of its equipment was off the shelf. You can imagine where it was all made.

My question, Ms. Craib, is related to the parts stream into the U.S. and our dependence on chips from China. Let's assume that the Chinese government carries through on its threats against the democratic Republic of China on Taiwan and uses military force, starts a war. We are going to be involved. And I would venture to say that would immediately stop the stream of semiconductors in China from coming back into the U.S.

I've never been able to get a good answer to this question. I'm taking advantage of your knowledge in the industry. But how long would it take American industry to shift its offshore production or

pick up production here so that we don't have an interrupted stream? And how dependent, if you can characterize it, is the Department of Defense, in particular, on semiconductors manufactured in China?

For Mr. Smith, my experience for about four and a half years as a military attaché in China is that the PLA film studio was one of the worst violators on optical media. They are Government run, nobody controls them. Are they still involved in such activity? Can you characterize their involvement in that kind of piracy?

Ms. CRAIB. To answer your question as best I can, we do keep statistics on the portion of demand coming from different industries, including the military.

Because of exactly what you said, commercial off the shelf purchasing, the number has fallen so low; it's well below 1 percent the last time we estimated it. I think it's actually very difficult for us to figure out exactly how much the military is using of our product other than the direct procurement number. So I'm not sure I can give you a complete answer on that, but what I would say is I don't know that DOD would be dependent on semiconductors directly made in China. But what I would say is that there is a significant amount of electronics production that takes place in China in terms of assembly that I think would have an impact on the U.S. economy.

But the U.S. semiconductor industry is global. We have, like I said, our advanced manufacturing here in the United States. There is packaging in China, but there's also Malaysia, Singapore; there's a lot of manufacturing in Europe. So I think in terms of semiconductor production, there are other areas that could pick up the slack if there were to be some kind of a conflict.

But I think what you would really be looking at in terms of vulnerability may not be so much militarily but in terms of economic vulnerability would be electronic assembly in both Taiwan and China in that specific case.

Mr. SMITH. With respect to your question on the PLA, in 1995-96, reports were pretty regular that the PLA was involved in the 35 to 40 plants that were producing and exporting this product. Many of those plants have been closed. And I think the Chinese government has, from what we're able to tell, and this is really all anecdotal and fourth-hand, they've managed to get the Government to some extent out of this business.

We're facing—and I'm sure there are government officials who are still involved in piracy in a big way in China or military people too—but we're really facing a lot of underground factories located in rural parts of China that are probably operated by powerful people within the provincial governments and things like that. But again, it's all kind of rumor and third hand.

But I think the ultimate point is that those people who operate these plants are not being deterred from being in this business, and you've got to take the money out of it, and China is not yet doing that.

Co-Chair REINSCH. Thank you.

Commissioner Dreyer?

Commissioner TEUFEL DREYER. Do you see, any of you, any realistic way to get the Government of China to comply on this? This

is—the figure you’ve given us is flabbergasting, over 90 percent of piracy. And as someone who spent more years than I care to remember studying China, you find a lot of ways that people can get around laws. In the case of the PLA factories being closed, in a lot of cases, what has happened is that people take off their uniforms, so they’re no longer PLA, but they still operate with the PLA, and someone can put a spouse in or a cousin or something like that.

In the case of compliance laws, you hear people saying blithely, well, they made real progress in passing new laws, and you know damn well they’re not obeying the new laws. Even if you catch them, they’ll say “we really can’t control what goes on in the provinces or the villages” and so on.

Are you at all optimistic that this thing can be made to improve, or are we stuck here?

Mr. SMITH. Let me give you an example, and these are countries that are different than China, so I want to make that clear at first.

When we started in Korea in the mid-eighties, piracy rates were 100 percent. Piracy rates are down to 10 percent, 15 percent now in Korea. That happened because they took tough deterrent action against and took the money out of it. They put people in jail; the fines were very high, and they devoted the kinds of resources to it.

In a way, the same thing happened in Taiwan. It’s got a little bit worse now. But in 1998, piracy rates went from 100 to 10 and 15 percent. So the answer is absolutely, it can be done. And I think China can do it, but they would have to—first, the Government would have to do something in a really coordinated, public way. They have given this mantle to Wu Yi now, but I don’t think as yet there’s been a public announcement of it.

The IPR problem is a loser for the Government. It’s intractable. Nobody wants to be—I’m guessing now, but I don’t think anybody wants to be responsible for dealing with it.

There is no criminal enforcement in China. There really isn’t, and it’s not so hard to do, and if they started doing it and putting people in jail for piracy— they put people in jail for smuggling and for operating illegal businesses, and sometimes, piracy is involved in those illegal businesses.

But the public is not being delivered the message that this is a crime in China, and it will be treated as a crime. And I’m not talking about putting people in jail for 50 years. I’m just talking about doing what other countries do, using deterrence to stop this kind of conduct. It’s worked in other countries; it can work in China.

Commissioner TEUFEL DREYER. But I would say, and you’ve acknowledged that these are very difficult countries.

Mr. SMITH. Yes.

Commissioner TEUFEL DREYER. One reason it worked in South Korea and Taiwan is because they’re relatively small countries.

Mr. SMITH. That’s right.

Commissioner TEUFEL DREYER. And it is easier for us to put pressure successfully on them than it is on China. Would you agree with that?

Mr. SMITH. Yes, the U.S. has done a fabulous job in many countries around the world on this issue. But ultimately, countries do not deal with their PR and piracy problems because the U.S. puts

pressure on them. They ultimately with it because they believe it's in their own interest.

And you continually hear Chinese government officials saying if we don't deal with our PR problem, we're going to be in trouble. Now, we can be low wage manufacturers for just so long. And that's what Korea and Taiwan realized 10 years ago, that they could no longer afford to allow this kind of piracy.

China will get there. We just don't know how to get them there faster. There are meetings after meetings, and they say all the right things, but for some reason, they just don't want to focus the kind of attention on this problem that needs to be focused on this problem in order to solve it.

Commissioner TEUFEL DREYER. Anyone else want to address that?

Mr. Primosch?

Mr. PRIMOSCH. I was in Hong Kong in November with Ambassador Shiner, and she specifically went there to look at how Hong Kong, the Hong Kong Government had turned around a very bad situation on piracy and counterfeiting. And it's interesting that many of the things Mr. Smith mentions were things that they did very vigorously; in fact, probably better than we do in the United States.

Not only did they have crack enforcement. They had 20 percent of their customs service devoted to anti-counterfeiting. They arrested people; they put them in jail; they fined them. They also had a public education program with their high schools and their universities to try to educate students on the importance of intellectual property rights protection. They also had comic books that they gave to kids. They had television spots.

So, China has a model very close by that's culturally very similar, and there are a lot of things that they could draw from by using the Hong Kong experience to make progress. And I think everyone recognizes that China is a big country; it's going to take time.

I think what we all want to see is progress, concrete progress and not just words.

Commissioner TEUFEL DREYER. Thank you.

Anyone else?

[No response.]

Commissioner TEUFEL DREYER. Thank you.

Co-Chair REINSCH. Thank you. I would only observe that one of the other factors here is that countries get a lot more interested in this when they have intellectual property of their own to protect. And as they move up that particular curve, this becomes a much more important element to them.

Commissioner Robinson?

Chairman ROBINSON. Commissioner Dreyer read my mind on that, so I'll be yielding my time.

Co-Chair REINSCH. Thank you.

Commissioner D'Amato?

Vice Chairman D'AMATO. Thank you, Mr. Chairman.

First of all I want to thank you all for what I think is excellent testimony. It's a powerful snapshot of Chinese performance in a di-

verse range of industries, everything from high tech, PR to basic products, wood, to semiconductors.

And frankly, it's alarming, because these problems are large, numerous; they're intractable, and then, the question of what do we do about them is up in the air. It's clear that the WTO is not a self-enforcing mechanism; that somebody's got to bring about enforcement.

And I want to ask both Ms. Craib and Mr. Smith about the question of filing a case. And you made the point, Ms. Craib, that once you file a case, you have a long time frame, and that's not in your interest. Well, then, the question is, how are we going to make the WTO case structure effective for us, if it's not in our interest to file a case?

That's what the main enforcement power is in the WTO. If we say it's too long to file cases, what have we got left? So that's the question I have.

Now, the thing that the Chinese covet most and use the most, of course is access to the United States market. They need access to our market. They've got a huge trade surplus. They care about that a lot. So, if we take away access from our market, you take away things that they care about. They might get serious about trying to enforce things like putting into place the criminal penalties, following the Hong Kong model.

They know what they have to do; they don't want to do it. So they haven't got the incentive yet to do it. It's up to us to give them the incentive, it seems to me.

But what would you do in the absence of a case? And why, again, is it that bringing a case is not in the interests of the industry that's aggrieved here? And what can we do to remedy that situation within the WTO?

Ms. CRAIB. First, just to clarify, our view is that a diplomatic solution would be optimal, because it could be quicker. That said, we have fully supported USTR's efforts to prepare for filing a case, and I think as is the case with any legal dispute involving businesses, including here in the United States, litigation is usually your last effort, because of the costs and acrimony and everything else involved in that process.

That said, when push comes to shove, and you have to address a problem, and you haven't been successful in any other way, you do file a case. And so, if USTR moves forward with filing, we would fully support that effort.

Again, as Charles Freeman indicated this morning, the Chinese have asked for a little bit of leeway until April of this year, when the next high level JCCT takes place. And we think that's a reasonable time line, again, given that the next step is a 30 to 39 month process.

Can a WTO case succeed in getting what we need? I think absolutely, it can. Our indication is that we have a strong case. I actually spent most of last week in Geneva talking to both the WTO Secretariat and the U.S. team there, obviously, but a number of other countries as well, who stand ready to support us in this effort. And I think part of what we're looking at is the investment decisions that are being made today.

And what needs to be made clear is that if people are relying on a WTO illegal VAT rebate when they're calculating whether to make a decision or not, they should be aware that that rebate may not be there, either within four months if there's a diplomatic solution, or after the WTO case comes to its conclusion.

Vice Chairman D'AMATO. Yes, as a lawyer, when you file a case, that sometimes does two things: it says to the other party that you're serious. It also initiates a settlement, so that you can get some action as a result of that if they think you're serious about it. If, in addition, there are other penalties that are put on the Chinese in other ways that make it more difficult for them to maintain the violations

On the PR area, what would you think, Mr. Smith? Do you think that filing a case together with perhaps some other things would be of use in terms of bringing the Chinese around to criminal enforcement?

Mr. SMITH. A little bit of history: I think our industries have been behind about 10 WTO cases to date, all of which have been settled, so we are no stranger to using the WTO remedy in our area.

China is now two years out from WTO membership. They made a lot of changes during this period. They made a lot of commitments. We have many of our members, particularly on the software side, who have huge investments in China, and everybody wants to give China a shot to get a handle on this.

And I think what I said today is that we're a little bit frustrated that they haven't—they've made noises about getting a handle on it, but we haven't seen the action yet. So, we're looking at it. And, we would agree with you that the WTO dispute settlement mechanism can be effective. It's worked for us, as I say, 10 times successfully; Japan, Sweden, a lot of issues have been resolved in this way that are important to us.

So, we are looking at this, but again, you can't do this right off the bat. You've got to give them a chance to come into compliance if they can.

Co-Chair REINSCH. Thank you.

Commissioner Mulloy?

Co-Chair MULLOY. Ms. Craib, Ms. Wroblewski and Mr. Primosch, you represent companies that make things here in the United States, and each of you, in your testimony, has said that the exchange rate issue and the Chinese intervention in currency markets to maintain an undervalued currency is a competitive problem that the United States Government should be seeking to address with the Chinese government. Isn't that correct? I thought I saw it all there; okay.

Now, I'm puzzled: there was another gentleman here who represents the U.S.-China Business Council, and I think he represents a lot of companies, too. He said that this is all—he used the word hoax. He said he wouldn't call it a hoax, but he thinks that it really is an issue that doesn't need to be addressed and is made too much about.

What is it in the perspective that his companies have and the perspective that your companies have that make him say it may

be a hoax, and you guys say it is a real problem and is really hurting your companies? Can you help me understand that?

Ms. CRAIB. If I can just answer very quickly, actually SIA has no position on that issue, and we do think the value added tax is our primary hurdle.

Co-Chair MULLOY. Okay; well, then, Wrobleski and Primosch.

Ms. WROBLESKI. I would bow to Bill's expertise, but let me try to answer it from our perspective. And it may be that Bob's companies are not specifically U.S. manufacturers. That sounds like a pretty easy fix, and I should let him answer the question and not me.

But when you put a group of our CEOs in the room, and they are unanimous in their view that they understand that they need to be globally competitive; they understand that they need to have the best technology; they understand that they need a trim work force; they understand all of those issues. But they say when I get my product to market, and all the other guy has to do is move his currency, and suddenly it's—take your pick, 5, 10, 20, 40 percent difference—it's got an impact, has to have an impact.

And that's the reason why we are—floating of the currency, you know, you'll get a lot of debates on both sides about sort of when and where and how that should happen. But is the currency weak artificially? We believe so.

The other issue, which I raised in my testimony and let me just say this, is that when the Chinese intervene in those markets, they accumulate a lot of, as I said, cheap money. And what we are seeing is that that cheap money is going into the, shall we say, famously imprecise Chinese banking system, and it then goes into state-owned enterprises to build capacity to export back into the U.S.

So it's almost—it's a double issue for us, quite frankly.

Co-Chair MULLOY. Could it be that the companies in the U.S.-China Business Council may be companies that have moved operations to China and manufacture there and ship back here, so it could be to their benefit to have an undervalued currency in China to help them sell back here?

Ms. WROBLESKI. I think I'd let Bob to answer that.

Co-Chair MULLOY. Mr. Primosch?

Mr. PRIMOSCH. Well, first, just to clarify our position, our position is China should have a market-based currency. That is our position, and we believe that their currency is not market based. It's significant under value. We're not saying that China should artificially appreciate the currency. We're saying it should be a market-based currency.

And I think the difference in view that you may get from talking to different companies is a large multinational company that has producers in China or maybe elsewhere in the world, their calculus changes all the time as to how currency rates affect their cost. And probably most of the membership of the U.S.-China Business Council are companies that, obviously, have major interests in China but are also invested there.

So their calculus is different, and some—and the fact that they're invested there doesn't necessarily mean that they would nec-

essarily support either one position or the other, but it is a difficult calculus, and I've heard this from many companies.

But our position is that it should be a market-based currency. You have a huge accumulation of reserves at a level much higher than what the IMF or World Bank would recommend for a country with China's level of trade, and we'd just like to see a more flexible market based currency, and we believe that if it was market based, you would see a substantial appreciation of the currency.

Co-Chair MULLOY. Let me just add one last thing. The way that this is structured now, I understand that some of the smaller American manufacturers who are afflicted by this and may be a supplier to a multinational—

Mr. PRIMOSCH. That's right.

Co-Chair MULLOY.—that the multinationals are encouraging them to move their operations to China so that they could sell cheaper to the multinational. I'm hearing that. Is there any truth to that?

Mr. PRIMOSCH. Well what we're hearing more often is that the larger company is being pressured, and some of these subcontractors, say, in the automobile industry or suppliers, they can be very large companies.

The automobile industry, in particular, is under a lot of pressure to reduce costs. We've heard that some of the large automobile companies are encouraging their suppliers to find the lowest cost base in the world to supply them. In many cases, that will be China.

Now, so, you have a double impact on the smaller companies. The smaller companies usually can't move. They don't have the assets to establish a base outside the country, a lot of them. Some do, and we have some successful small companies in China.

But what happens to even probably smaller companies is their customers have moved to China. The tool and die people in Illinois, for example, if you've talked to Congressman Manzullo, this is what he'll tell you. He said there's not all that much import competition; there is some, and some of it can be pretty tough.

But he said the bigger problem is that the tool and die people's, the companies' customers have moved to China, and they're supplying the tool and dies in China and not in the United States. So that is frequently what you hear, too.

Co-Chair MULLOY. Thank you. Thank you very much.

Co-Chair REINSCH. Thank you.

Commissioner Becker?

Commissioner BECKER. Thank you, Mr. Chairman. Just one comment, first on the intellectual property rights and a couple of other items that fall into that category, like the VAT. We had testimony earlier this morning from Terry Stewart, who processes trade cases and he told us the tools are there. It's a lack of political will to get the job done. Which reminded me, at least four years ago, I was on the Trade and Environmental Policy Advisory Committee to the USTR, and Jack Valenti came in and talked to us. This was four years ago and it was the same testimony that you're giving; the same exact problem, and if anything, it's grown since then.

I want to ask a question, because we've got a diverse group here of manufacturing. You have plants in China; you have plants here or represent people here in the United States both.

We haven't talked much about the deficit here today, but we keep coming back to that. We have a soaring deficit. It's running about \$125 billion a year with China. It's an escalating one. We have somewhere in the neighborhood of 3 million jobs that have been lost, and nobody seems to get very excited about that.

And I keep reading different economists say that this is non-sustainable. I don't know if I know what that means, because we've been sustaining it. But Warren Buffet, for example, gave an interview in *Business Week* about a month ago in which he said for the first time in his life, he was investing in euros and selling American dollars.

He says it's not sustainable, and it won't be sustained. So I just ask your opinion on this: as management representatives, if nothing changes, and we continue to buy at the rate that we are the increasing amount to the deficit month after month after month, and we keep losing manufacturing jobs. Where do you see this taking us over the long haul? What do you think we're going to have in 10 years? Could you just give me your feeling of how this is going to spin out?

Mr. PRIMOSCH. I think looking out 10 years it's awfully hard to predict the future; when we were looking at the problem of—

Commissioner BECKER. Go a year.

Mr. PRIMOSCH.—with Japan.

But I think what's going to come sooner than the economic impact is the political impact, and with the trade—at a 25 percent rate of growth of the trade deficit every year, which is what it was last year, 25 percent, and that's been about the trend; that means every three years, the trade deficit doubles.

And I think the first impact is going to be political, because I think politically, it will be unsustainable before you have to deal with the economic issue, and I just wonder how the U.S. Congress is going to react as this trade deficit continues to balloon, and Congress hears about the kinds of trade problems that we have been discussing.

The longer-term economic impact, I think it will depend a lot on different industries and segments of industry. I know a lot of our traditional manufacturing is very concerned that they're going to lose; a lot of it will erode very significantly over the next 10 years unless there's a more level playing field, and some of these trade are addressed.

For all of U.S. manufacturing, we are a—let's not be too pessimistic; we're the most dynamic, most innovative manufacturing sector in the whole world. We have some of the hardest working workers, some of the most innovative people. So let's not sell ourselves short. But I think for some segments of industry, they feel that they're in crisis, and I think looking out several years from now, it doesn't look good.

Ms. CRAIB. If I can add something very quickly, if you look at media coverage of the U.S. semiconductor industry circa 1985 or so, our death was quite widely reported, and today, we're more than 50 percent of world market share, and that was due to combined

factors: one, us working very hard to retain technological competitiveness; that's something we're still doing; but also, frankly, we worked very closely with USTR, and they got us market access in Japan, which at that point was the largest market in the world and the fastest growing.

So we see some real parallels. And sitting on our board of directors are a number of people who were founders of the SIA, and they founded SIA to deal specifically with the challenge from Japan. They remember that very clearly, and they see this as a very similar situation, and so we do feel that addressing this is very important, and if we do we're going to be able to retain our competitiveness here.

Mr. SMITH. Our industries are a little bit different. I'll let others speak about manufacturing.

Copyrights are produced here. Software is produced here, movies, music. These industries are employing U.S. workers at about three times the rate of the economy as a whole. Our problem is not one of a deficit, and we have no position on that. Our problem is that we have the product, which is in huge demand in China, and we cannot satisfy that demand because we're kept out. We are kept out in two ways: 90 percent piracy rates; you cannot compete in that kind of a market.

You cannot bring our products—the software industry in China is growing at double-digit rates, and if we could sell our products there in the way we can sell them in other countries, the deficit would definitely come down. And I will tell you if we could sell—20 films are allowed to get into China every year now, American films. If we could break that quota and bring all of these films into China, the deficit would go down.

So, we're looking to open up that market. It just isn't open for our industries yet.

Co-Chair REINSCH. Thank you.

Commissioner Mulloy, you have one last question.

Co-Chair MULLOY. Ms. Craib, on that, it wasn't just USTR that you worked with them. Wasn't there some other SEMATECH or something that was set up? It was a joint Government-industry effort to help the competitiveness of that industry? It wasn't just free market that worked that, was it? There was a Government role, I remember, in that whole area.

Ms. CRAIB. Yes, you must have read my talking points, actually.

What we did at that point was work with the Government to ensure that we had precompetitive technological superiority, and at this point, the SIA board, to deal with the challenges that we face now, has identified two key platforms. One is effective market access, and the other is adequate funding of university-based R&D, which is precompetitive.

Our industry invests millions of dollars. The Semiconductor Research Corporation, which was founded by SIA, spends about \$50 million or \$60 million a year on that. But we need the U.S. Government involved in that effort as well, and so, we do see those as kind of dual supports for obtaining competitiveness.

Co-Chair REINSCH. Thank you very much.

Co-Chair MULLOY. No, I want to finish.

Co-Chair REINSCH. Pat?

Co-Chair MULLOY. Bill, let me finish.

My recollection is this is a national security issue, the survival of this industry. And so, the Government got in and played a role.

And I think that's what we're looking at: does the erosion of all of this, does this have national security implications? And we ought to maybe step up our concern.

Thank you.

Co-Chair REINSCH. Thank you very much.

I've been asked to let you know that the panels will be receiving transcripts of your remarks early next week, and we'd appreciate if you could get them back to us promptly so that we can publish the proceeds and get them out for everyone to read within two or three weeks.

Thank you very much for coming. We appreciate your contribution. This concludes the hearing.

[Whereupon, at 4:48 p.m., the hearing was concluded.]

**Statement by Timothy P. Trainer,
President, International AntiCounterfeiting Coalition, Inc.**

**Preliminary Report on Counterfeiting Practices in the People's Republic of
China**

PEOPLE'S REPUBLIC OF CHINA (PRC)

Introduction

In 2003, there has not been any significant progress. China continues to pose the greatest threat to IACC members' intellectual property (IP) assets as compared to other countries in the world. Based on our efforts to determine the general global counterfeiting situation, China has no equal when looking to source country and the volume produced for its domestic and export markets. Despite significant improvements made to China's IP legal regime, which we have noted in previous filings, the enforcement system continues to be fraught with weaknesses and inefficiencies that result in massive counterfeiting and piracy.

If there is one positive note to underscore, it is the "Market Order Rectification Office" (MORO), under the Ministry of Commerce, which is an inter-departmental coordination office of the government. It has agreed to meet with industry (via the Quality Brand Protection Committee and other groups) every quarter to discuss outstanding IP issues. Industry is optimistic that this may provide a vehicle for an active exchange of views for resolving some of these difficult enforcement issues. The first meeting was held in December and a second meeting is already scheduled for March 2004.

As in the past, it is not a question of what is counterfeited in China, but what is not counterfeited in China.¹ The fundamental illegal activity of counterfeiting in China becomes much more heinous because of the counterfeits that pose significant public health and safety concerns. The list below is a snapshot of the types of products counterfeited in China, some that pose serious safety hazards for consumers.

- Batteries
- Razors
- Medicines
- Shampoo
- Cigarettes
- Auto parts (e.g., oil filters, headlamps, windshields, spark plugs)²
- Industrial valves
- Vision wear
- Apparel
- Air compressors
- Portable tools
- Power strips
- Extension cords

In addition to the impact on IACC member companies, China's counterfeiting industry has a direct impact on foreign governments. The U.S. Department of Homeland Security's Bureau of Customs and Border Protection reported the seizure of 2,056 shipments from China for containing counterfeit and pirated product, having a value of over \$62 million dollars.³ In addition, China is the top source of counterfeits found in Japan, which includes many products that are counterfeits of our members' brands.⁴ Similarly, the European Union has also found that China is a leading source of counterfeit and pirated products to its borders.⁵

Economic Impact—Based on Enforcement Actions

IACC Member companies, for the most part, have not provided loss estimates. However, the results of enforcement actions provide a glimpse into the economic harmful economic impact that China's counterfeiting industry has on IP owners.

China's production and export of counterfeit goods is a tale of organized illegal activity that attracts profiteers of many nationalities. A member auto company's

¹*Associated Press Worldstream*, (January 27, 2004). Chinese police raid fake prison, find disguised cigarette factory. Over 100 tons of tobacco found in the fake prison where 20 brand names were being used.

²*Automotive News Europe* (November 17, 2003). Authorities cite brake linings made of compressed grass, sawdust or cardboard, and oil filters that use rags for the filter element.

³These Fiscal Year 2003 statistics place China at the top of the list of countries as the source of infringing goods stopped at the U.S. border.

⁴*Asahi Shimbun*, "Training Program to Combat Counterfeits" (February 3, 2004).

⁵*European Report*, "Customs: Rise in Counterfeit Goods Seizures" (November 26, 2003).

raid of a Chinese auto parts factory uncovered 7,000 sets of counterfeit brake pads intended for export to Egypt. The single raid represents potential losses of nearly \$330,000.⁶ Another auto industry member reported raids resulting in the seizure of thousands of counterfeit windshields and several thousand suspension control arms, valued at nearly \$4 million dollars total. A third auto industry member estimates that 50%–60% of counterfeit parts bearing its trademarks found in the world are made in China.

An IACC member, whose certification mark is relied upon as a mark of safety, reported that of the 91 seizures made by U.S. Customs in 2003 because of counterfeiting, approximately 65 shipments were from China. These seizures included a \$1.5 million dollar seizure of air compressors that had counterfeit ground fault circuit interrupters, \$700,000 of counterfeit extension cords, power strips and hair trimmers that, in turn, led to a \$7 million dollar seizure of counterfeit extension cords and power strips. In addition to the Customs seizures, another \$1 million dollar seizure of Chinese made counterfeit portable and hand tools was made by police in southern California.

An Australian investigation of two Australian nationals led to the discovery of a massive counterfeit operation of Chinese made batteries and razors, which were counterfeits of IACC members. Three containers heading to different ports—Dubai, Oman and Los Angeles—were seized having counterfeit goods valued at \$1.5 million dollars.⁷ Australian authorities also seized two shipments (50,000 bottles) of counterfeit shampoo from China bearing the trademark of a famous brand.⁸

Canadian authorities seized 60,000 counterfeit “Duracell” batteries before the holiday season and warned consumers because of potential hazards if used in toys.⁹ In New York City, the NYPD busted an international counterfeiting ring that smuggled pricey counterfeits from China to New York. The NYPD busted the distribution center in Chinatown. The center was warehousing about \$2 million worth of counterfeit designer handbags, sunglasses and clothes, as well as racks of illegal CDs and DVDs of hit albums and movies, in a storefront and two sub-basements.¹⁰

China’s counterfeit tobacco production and export of major brands is testing enforcement officials around the world. U.S. authorities broke up a ring in Texas that is believed to have imported over 100 million counterfeit cigarettes, mislabeling shipping documents by indicating that they were importing toys or plastic parts.¹¹ Austrian authorities charged seven people with smuggling over \$19 million dollars worth of counterfeit cigarettes, which were described on shipping documents as kitchen utensils, scooters and suitcases.¹² U.K. Customs arrested ten Polish nationals after 44 million counterfeit cigarettes were discovered in eight containers that had arrived from China in the summer of 2003.¹³

In contrast to these large shipments, one IACC member reports that counterfeit cell phone covers, belts, watches and other products bearing its marks have become difficult to detect due to small quantity shipments going via the postal systems. If a person is caught, the penalties, if any, are smaller due to the smaller quantities of counterfeits involved.

In China, counterfeit vision wear products bearing member trademarks are plentiful in Guangzhou. For one IACC member, the counterfeiters are using its mark on a product that the member does not produce.

One member company reports that it is spending over \$5 million dollars to combat counterfeiting in China. Although over a quarter million counterfeit batteries and nearly a half a million counterfeit labels have been seized in the past year, counterfeiting of its products continues. Despite the enforcement actions, the resulting sanctions have been inadequate, ranging from officials stating that the amount involved failed to meet thresholds for criminal action to refusal of administrative authorities to investigate the individuals involved.

Finally, the Development Research Center (DRC) under China’s State Council released a report in July 2003 on the damage that counterfeiting inflicted on China’s economy. According to the DRC report, the market value of counterfeited goods in China was estimated at 160 billion to 200 billion yuan (19 billion to 24 billion U.S. dollars) in 2001.

⁶ *Forbes Magazine*, “Stolen Cars” (February 16, 2004).

⁷ *The Sunday Telegraph*, “Counterfeit Gang Foiled” (January 4, 2004).

⁸ *Herald Sun*, “Shampoo Didn’t Wash” (December 25, 2003).

⁹ *The Vancouver Sun*, “Bogus Batteries Pose Safety Threat” (December 12, 2003).

¹⁰ *The New York Post*, “Pirates Sacked—Chinatown Fake-Goods Ring Cracked” (December 3, 2003).

¹¹ *The Dallas Morning News*, “Tobacco-Smuggling Ring Busted” (January 29, 2004).

¹² *Associated Press Worldstream* (July 29, 2003).

¹³ *Mail on Sunday (London)*, (August 3, 2003).

The above examples simply point to the global resources of IP owner's and governments to combat China's counterfeiting industry, which has a global reach and is so extensive that the actual economic impact on a particular industry is practically impossible to estimate. The DRC's estimates underscore the significant impact on the local Chinese market with billions lost in tax revenues. In view of some of the staggering quantities and values associated with the seizures noted above, it is easy to conclude that China's rampant counterfeiting is causing an enormous diversion and drain of corporate resources to simply gain a better awareness of the scope of this problem—many in industry are not ready to state that these enforcement actions have led to controlling the problem.

Trademarks

Despite the amendment of the Trademark Law in 2001 and a five-fold increase in the fines, there is no minimum fine set forth in the law. Thus, despite the increase in the upper limit, the experience is that the imposed fines have decreased. Over the last two years, different departments of the Chinese government have been considering new measures to address critical problems in existing laws and regulations relating to trademark protection. These include (a) the issuance of new judicial standards for criminal liability in counterfeiting cases; (b) new customs regulations on the protection of IP; and (c) new regulations to assist local authorities in calculating fines and other administrative penalties in trademark infringement cases.

Criminal Liability Standards and Enforcement

The lack of clear and reasonable standards for determining whether a counterfeiter may be criminally prosecuted, rather than merely subject to administrative fines and seizures, represents the single biggest barrier to deterrence in anti-counterfeiting work by both government and industry in China. Fortunately, the Supreme People's Court (SPC) and the Supreme People's Procuratorate (SPP) have both set up study groups to deal with the issue and develop new standards to replace those hastily issued in April 2001 by the SPP and Ministry of Public Security (MPS). However, it remains unclear exactly when they will issue any new standards, and whether they will ultimately be effective.

Under the TRIPs Agreement,¹⁴ any prosecution standards should, in principle, facilitate criminal enforcement against any offender involved in counterfeiting on a "commercial scale". At present, very few such counterfeiters are subject to criminal sanctions in China, and administrative sanctions imposed on them fail the TRIPs-mandated standard of "effective" enforcement that has a deterrent impact.

Existing criminal prosecution standards set out numerical standards for determining whether a producer or vendor of counterfeits may be prosecuted. For example, an enterprise infringer may be prosecuted if it is determined to have produced or sold more than US\$60,000 in fakes. This amount is arguably too high, given the fact that most counterfeiters do not maintain documents indicating the scope of their prior production and sales. What is of greater concern to all is the lack of a clear and simple method for calculating the value of counterfeit goods. The SPC and SPP are aware of these problems and they are currently considering the options for resolving them.

Industry believes that any new standards should take into consideration the price of the victim's genuine product, rather than rely on the infringer's declared price or other methods. Moreover, it is recommended that, consistent with international practice, criminal prosecution automatically be pursued in all cases involving producers of counterfeits, i.e., without any numerical standards imposed.¹⁵ Experience proves that it is extremely rare for any counterfeit manufacturer to produce fakes in small quantities, and it is equally rare for brand owners or government enforcers to detect such producers right at the commencement of their illegal activities. Thus, it is reasonable to assume that virtually all counterfeit manufacturers have already produced and sold fakes in quantities that exceed current criminal liability standards by the time they are detected or raided by relevant authorities. Indeed, the references to raids and enforcement actions noted above support this contention.

It is also recommended that the calculation of the value of fakes seized from manufacturers take into consideration semi-finished products and components. Under current policy, such items are given little importance, thereby creating a major loophole for counterfeiters, as they will routinely assemble and ship products within a

¹⁴The World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights.

¹⁵The U.S. federal criminal statute against trafficking in counterfeit goods does not have any threshold value that must be met. See 18 U.S.C. § 2320.

short period of time and often at night, thereby making seizures and arrests very difficult.

It is also recommended that steps be taken to ensure that counterfeiting cases initially handled by the Technical Supervision Bureaux (TSBs) that cannot be criminally prosecuted under Article 140 of the Criminal Code (governing the sale of fake/inferior goods) be promptly transferred to relevant police organs for investigation and prosecution under Article 213–214 of the Criminal Code (governing trademark counterfeiting). Under current policy, the TSBs will routinely refuse to transfer to the police cases that do not involve fakes which fail to meet national product quality standards. This also creates a significant loophole in criminal enforcement.

The Ministry of Public Security (MPS) and local police organs in areas where IP protection is a problem need to set up special IP divisions. Industry is encouraged by the fact that the MPS may be planning a reorganization that would establish these specialized IP divisions. Currently, criminal enforcement against trademark counterfeiting is handled by the Economic Crimes Investment Division (ECID). This division would need to be split into two in order to realize such a reform.

Recommendations:

- adopt the price of legitimate products as a basis for calculating “illegal business amounts”;⁸ adopt the same numerical standards for enterprise and individual infringers;
- clarify the standards for pursuing criminal responsibility of original equipment manufacturer producers and trading companies involved in the export of counterfeits, include provisions specifically targeting underground operators, recidivists and parties that knowingly facilitate counterfeiting, such as landlords, transporters, suppliers of raw materials, financiers and others;
- issue clear standards for determining when criminal investigations should be initiated; and
- target the individuals behind the counterfeiting operations and networks in order to use limited resources efficiently.

Well-Known Trademarks

The Trademark Office issued new regulations on the protection of well-known marks, effective June 1, 2003, and pursuant to Art. 13 of the Trademark Law (as revised effective Dec. 1, 2001). The Trademark Review and Adjudication Board (TRAB—an appeal board over the Trademark Office) has reportedly issued two recent decisions citing Art. 13. The trademark community is hopeful that the TRAB is finally acting on applications for well-known status.

Despite the possible good news from the TRAB, no decisions of the Trademark Office have been seen and, of greater concern, local offices of the Administration for Industry and Commerce are unwilling to accept applications for well-known status in connection with the unauthorized use of well-known marks inside company names. The lack of specific procedures and regulations is being cited by local authorities in this regard. The trademark owners believe that this is to mask the fact that there are different divisions in the State Administration for Industry and Commerce that disagree on how things should be dealt with.

Administrative Penalties under the Trademark Law

A revised version of the Trademark Law’s Implementing Regulations entered into effect on September 15, 2002. These regulations provide for substantially increased administrative fines against infringers, i.e., up to three times the “illegal business amount”, or in cases where the scope of production or sales is unclear, discretionary fines up to RMB100,000 (US\$12,000). The Trademark Law itself separately provided for the “confiscation and/or destruction” of infringing goods in all cases. However, there are still no clear standards for enforcement authorities to rely upon to determine the appropriate level of fines in a given case. The lack of such standards—and in particular minimum fines—leaves a large loophole for “protectionism”.

Industry recommends that minimum fines of 150 percent of the value of goods should be considered in any case involving counterfeits, with even higher fines required in cases involving repeat offenders, refusal of infringers to cooperate with government investigations into the source of fakes or labels, and infringers operating without a business license.

The current Trademark Law and Implementing Regulations likewise fail to provide standards for determining when seized counterfeit goods are to be destroyed, as opposed to merely having infringing labels removed and the goods donated to charity or auctioned off. Industry recommends that there should be no auctioning of counterfeit goods without prior approval of the trademark owner.

Trademark owners have perceived no significant change in the level of deterrence created by administrative enforcement actions undertaken pursuant to the new Trademark Law and Implementing Regulations thereto. Greater deterrence can only be realized by addressing the above issues.

Trademark Office officials of the State Administration for Industry and Commerce (SAIC) have indicated that it is planning to issue new guidelines to address these issues, but no firm timeline has been announced. Industry is concerned that any regulations issued by the Trademark Office will not be entirely effective. Most anti-counterfeiting work within the SAIC system is handled by the Economic Supervision Divisions of local Administrations for Industry and Commerce, which are not managed by the Trademark Office, but rather by the Fair Trade Bureau of the SAIC. Accordingly, it is recommended that the SAIC itself issue the required regulations due to its ability to issue instructions to both with agencies.

The SAIC issued an "opinion" in 1994 dealing with these problems, but given the recent amendments to the Trademark Law and Implementing Regulations thereto, the contents of this opinion clearly need to be updated.

Finally, printers and packaging suppliers of trademarked goods should be the subject of special rules regarding administrative enforcement. Presently, they are subject to very modest fines, based on the value of the goods seized—which is almost always low to begin with.

Transparency

Decisions issued by TSBs and most Administration for Industry and Commerce divisions in the course of enforcement are not automatically provided to brand owners, or otherwise made available to the public and for publicity purposes. Likewise, decisions of the Trademark Office and TRAB are not made available—even to Chinese lawyers. And parties involved in oppositions and cancellations for non-use do not get access to the other side's arguments and evidence. Arguably, withholding decisions on the merits, such as these, are violations of TRIPs.

Copyrights

Criminal liability standards are a continuing problem, but a bigger problem is the lack of interest in enforcement by the police division responsible for copyright crimes—the Social Order Division. This division has been reasonably proactive in dealing with CD plants, but not with virtually any other copyright crimes. Hopefully, responsibility will be shifted out of this division to the new department being considered for trademark cases.

Customs

China's State Council recently issued new regulations entering into effect on March 1, 2004, that replace earlier regulations from 1995 on the protection of IP rights by local customs offices. While we commend the effort to issue new regulations and the transparent process that allowed industry to provide its comments and concerns, several issues remain problematic and need further clarification. Absent further clarification and amendment, the new regulations may have the effect of deterring IP owners from using the customs measures as an enforcement tool.

Bonding Requirements

The bonding requirements in cases involving obvious counterfeits need clarification. The new regulations give customs the flexibility to fix bond amounts at somewhere between nothing and 100 percent of the value of the counterfeits. Future implementing rules or policy papers should make clear that counterfeits should only attract the lowest possible bond.¹⁶

Storage Costs/Disposition of Counterfeit Goods

The cost of storage and disposition of counterfeits lies with the IP owner under the new rules. This is regrettable, and it may well deter lots of IP owners from recording their rights with Chinese customs, much as bond requirements have done so in the past. Procedures in line with TRIPs Article 59 should provide for the Government to order destruction of counterfeits rather than place the burden on IP owners. Moreover, given the potential high cost of storage, procedures should be

¹⁶The new European Council Regulation 1383/2003, July 2003, takes effect on July 1, 2004 and states that rather than a bond, IP owners are to submit a declaration accepting liability. Article 6. The World Customs Organization's new Model Legislation concerning Border Measures (February 2003) has in the notes accompanying Article 10 suggestions and recommendations that Customs authorities permit a continuous bond so that IP owners are not under a constant obligations to post new bonds for each shipment that is stopped. The notes also adopt the new European Council approach of a declaration rather than a bond.

adopted that are clear as to administrative handling of cases with the possibility that destruction could occur except for samples as evidence once a definitive decision on the goods has been made.¹⁷

Criminal Transfer

The new regulations provide, at least in theory, the possibility of a criminal transfer. Future implementing rules and other practical measures absolutely must be introduced to ensure that such transfers actually take place. Absent the possibility of transferring customs cases for possible criminal investigation and prosecution, there is no deterrence.

Information Disclosure

Access to information must be guaranteed to IP owners. Unfortunately, the new regulations do not address this issue. Chinese officials should be encouraged to provide for the disclosure of information regarding persons involved to the IP owners. Given the information disclosure possibilities under the European Council Regulations and U.S. regulations, this would simply make China consistent with many other countries.

Recommendations:

- consider the European Council approach regard bonds or a nominal amount for a continuous single bond;
- Require destruction of a pirated and counterfeit goods;
- Provide for the imposition of penalties that require the importer/exporter to pay for storage costs or impose a time certain for either administrative decisions on the issue of infringement that permits destruction except for samples as evidence in judicial proceedings;
- Clarify the regulations regarding case transfers for criminal investigations to determine the manufacturers of counterfeit and pirated product; and
- Encourage information disclosure regarding importers, exporters, consignees, etc., in order to engage IP owners in the pursuit of violators.

IACC members urge the U.S. Government to re-examine the February 26, 1995 U.S.-China exchange of letters between Minister Wu Yi and Ambassador Kantor regarding IP enforcement. In the exchange, China committed to stop shipments intended for export that contain infringing goods. Moreover, China committed to taking steps to stop the cross border trade of infringing goods ex officio. In view of the massive volume of counterfeit and pirated product now found around the world, the IACC requests that the U.S. Government emphasize China's nine-year old commitment to stop such shipments.

Enforcement Bodies: Coordination

The current enforcement system of multiple agencies and ministries creates an overly complicated system that creates loopholes and provides opportunities for protectionist behavior. Currently, there is too much overlapping authority and lack of coordination among the various administrative enforcement bodies. The current list of agencies involved in enforcement includes the Trademark Division of the AICs, Economic Supervision Divisions of the AICs, TSB, Customs, Social Order Divisions of the Public Security Bureau, ECID of the Public Security Bureau and others. One common example of such problems is the difficulty in promptly transferring criminal cases from the TSBs to the ECIDs, notwithstanding the fact that the relevant standards for criminal investigation and prosecution under Art. 213–215 of the Criminal Code have clearly been met.

Recommendation:

- Encourage the central government to research methods of improved coordination and implement changes in order to eliminate overlap and complexity of the enforcement system.

Foreign Trade Law

The Chinese government is currently amending the Foreign Trade Law. The IACC requests that, to the extent possible, the amendments to this law address enforcement issues impacting trade. Given that the import and export of goods is trade related, a provision in the law to criminalize the export and import of counterfeit and pirated goods would be a positive step. In addition, the IACC recommends that the amendments also include penalties for businesses, e.g., trading companies, etc., in-

¹⁷A legal determination as to whether the goods are counterfeit or not should be separate from a decision regarding the sanctions to be imposed upon the persons involved.

volved in arranging, processing, goods for import or export be within the scope of the law for purposes of penalties if counterfeit or pirated products are involved.

Conclusion

The China counterfeiting and piracy problem is so massive that it is difficult to provide a short list of steps that our members believe are necessary. Several bullet point recommendations are provided above. There is no doubt that the points and the points below, some that repeat our stated concerns, are part of the package of industry's issues regarding elements of the enforcement system that need to be addressed.

- Imposing of more severe penalties (fines paid/prison terms served);
- Issuing of clearer standards by relevant courts and authorities and communication of such standards to enforcement authorities at all levels;
- Penalizing repeat offenders with higher level of sanctions;
- Ensuring destruction of goods, and to the extent legally possible, seizure and destruction of the materials and implements used to produce the counterfeit and pirated goods; and
- Seizing any documentation as evidence during raids.

**Statement of Brad Smith
Managing Director for International Relations
American Council of Life Insurers**

Overview

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

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

Based on draft regulations released by CIRC in August 2003, we are cautiously optimistic that our primary concern to date (unjustifiably high capitalization requirements) has largely been addressed. As the next step, we have submitted a detailed list of additional questions to which we are seeking clarification from CIRC. Beginning in September of 2003, USTR has formally requested answers to the same questions through the WTO's Transitional Review Mechanism and the Committee on Trade in Financial Services regular meetings, but to date the CIRC and Chinese trade representatives have only stated the revised regulations would be released in the near future.

We feel strongly that it is important for CIRC to review with us the draft regulations and the questions and concerns we have raised before the regulations are finalized. Deputy Assistant USTR for China Charles Freeman reiterated this request formally in a December letter. We hope that CIRC can schedule this meeting in the near future.

Background

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

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

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

Individual company experience with CIRC varies greatly. Some describe relations as perfect and others describe them as frustrating, but our member companies support this constructive engagement approach for the same reasons many companies have funded representative offices all over China, some going back for more than ten years. The Chinese market is seen to have tremendous potential, and many U.S. companies, like our international competition, see entry into China as key to a global strategy.

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

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

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

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

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

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

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

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

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

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

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

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

Also, in both instances, we submitted formal written responses to CIRC within the requested time frame. We commended them for their public outreach, and stated that their openness supports our firm belief that the most important factor contributing towards the successful development of the Chinese insurance sector will be the institutionalization of a regular and robust public dialogue. We expressed our hope that this initiative can be expanded through increased communication and cooperation with interested international companies and industry associations, and committed ourselves to provide professional and timely responses to CIRC on an ongoing basis. We also stated that a dialogue on these drafts and/or any revised drafts that CIRC circulates for additional comment would be an excellent basis for continuing the dialogue we began in December of 2002 in Beijing.

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

Continuation of this dialogue must be two-way. Many of our concerns involve confirmation of our understanding of the meaning of vague or conflicting regulations. So that this dialogue is as clear as possible, we hope to receive written responses to our inquiries from CIRC. This has also been requested by USTR.

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

Fundamental Assumptions

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

Fundamental Assumption—1

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

Fundamental Assumption—2

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

Fundamental Assumption—3

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

Fundamental Assumption—4

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

Fundamental Assumption—5

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

Implementation Gaps

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

Implementation Gap—1

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

Implementation Gap—2

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

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

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

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

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

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

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

*Implementation Gap—3*In addition to its insurance and reinsurance liberalization commitments, China committed to liberalize its pension market within five years of joining the WTO. To date, no regulations or laws have been released in anticipation of the opening of this important market sector. CIRC or other relevant authorities, should begin a public comment process well in advance of the approaching phase in deadline to gain the broadest level of comment and support for this fundamental undertaking.

National Treatment Questions

In addition to the questions on fundamental assumptions and the further information needed to fill the implementation gaps, we would also like to receive confirmations from CIRC on the following specific questions regarding national treatment.

National Treatment Question—1

RE: Article 3 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly we interpret it to say that with respect to branch boundaries for foreign invested insurance companies, that they are treated the same as domestic companies which we understand are defined at the provincial-level (On May 21, CIRC approved Min Sheng Life to prepare 4 branches in Beijing, Nanjing, Hangzhou, and Shijiazhuang. (Source: China Insurance News, June 2003) If this is a correct understanding we believe that it is more efficient, and is a major step forward for CIRC in fulfilling their mission to implement China's WTO national treatment obligations. Domestic companies are able to operate at the provincial level with access to all cities and localities in the province. To date foreign companies have received approval to operate at only in one specific city. Foreign companies like their domestic counterparts should have provincial level licenses.

National Treatment Question—2

RE: Article 11 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly, we interpret it to say that with respect to branch applications for foreign invested insurance companies, that they are treated the same as domestic companies which we understand can apply for any number of branch approvals simultaneously with no limit to the number of branches a company may be granted at any given time.

National Treatment Question—3

RE: Article 13 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As there is no reference to any waiting period, we request confirmation in this article that no waiting period exists before licensed insurance companies, domestic or foreign, can apply for branch or sub-branch licenses.

National Treatment Question—4

RE: Article 99 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As it is so vague, we are concerned that Article 99 could be used to justify discrimination against foreign insurers, contrary to China's WTO commitments on national treatment. Accordingly, we would urge confirmation that the scope of Article 99 is limited solely to matters where the prudential justification will be clearly explained and limited to as least discriminatory as possible.

Prudential Justifications

In addition to the questions on fundamental assumptions, the further information needed to fill the implementation gaps, and questions of national treatment we would also like to receive responses from CIRC on the following questions of prudential justification.

Prudential Justification—1

RE: Article 6 (b) of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the capitalization requirements. We believe that RMB200 million is too prescriptive in nature and may be much higher than international norms with respect to specific business models and risks being assumed. We feel that CIRC should be granted the discretion to lower this amount where it feels appropriate. Also, we request clarification of the scope of the initial establishment of RMB 200 million. Please confirm that this includes the right to establish sub-branches without limitation as to numbers.

Prudential Justification—2

RE: Article 12 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the branching capitalization requirements of RMB20 million for each additional branch. We feel this is duplicative, contrary to China's WTO commitments, and has no prudential justification. Additionally we feel it is an inefficient use of capital, which will raise the cost of products to Chinese consumers.

In summary, it is vitally important that all parties work together in a clear and open manner to ensure understanding of CIRC's implementation process. Any measures China implements that give the impression of falling short of its WTO commitments and denying U.S. insurance companies meaningful market access in China could create hostility. Thus, it is in the interests of CIRC to continue a meaningful two-way dialogue to make the implementation of China's WTO insurance commitments as smooth and positive as possible.

ACLI and our industry colleagues continue to appreciate the hard work and high-level leadership of USTR and the other relevant U.S. Government agencies that have helped establish and grow this dialogue with China. Likewise, the industry greatly appreciates the ongoing support of Members of Congress. We consider ourselves still near the beginning of a complex process, and will look forward to an ongoing relationship with your commission as we proceed through the years to come. While we do not know when China's draft regulations will enter into force, it is our hope that our dialogue, with your and the government's assistance, will produce a transparent and effective body of regulations comporting with China's strong and admirable WTO commitments. We will report to you as circumstances develop.

Thank you for your interest and consideration in this matter.

**STATUTORY MANDATE OF THE U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION**

Pursuant to Public Law 108-7, Division P, enacted February 20, 2003

RESPONSIBILITIES OF THE COMMISSION.—The United States-China Commission shall focus, in lieu of any other areas of work or study, on the following:

PROLIFERATION PRACTICES.—The Commission shall analyze and assess the Chinese role in the proliferation of weapons of mass destruction and other weapons (including dual use technologies) to terrorist-sponsoring states, and suggest possible steps which the United States might take, including economic sanctions, to encourage the Chinese to stop such practices.

ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.—The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.

ENERGY.—The Commission shall evaluate and assess how China's large and growing economy will impact upon world energy supplies and the role the United States can play, including joint R&D efforts and technological assistance, in influencing China's energy policy.

UNITED STATES CAPITAL MARKETS.—The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.

CORPORATE REPORTING.—The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.

REGIONAL ECONOMIC AND SECURITY IMPACTS.—The Commission shall assess the extent of China’s “hollowing-out” of Asian manufacturing economies, and the impact on United States economic and security interests in the region; review the triangular economic and security relationship among the United States, Taipei and Beijing, including Beijing’s military modernization and force deployments aimed at Taipei, and the adequacy of United States executive branch coordination and consultation with Congress on United States arms sales and defense relationship with Taipei.

UNITED STATES-CHINA BILATERAL PROGRAMS.—The Commission shall assess science and technology programs to evaluate if the United States is developing an adequate coordinating mechanism with appropriate review by the intelligence community with Congress; assess the degree of non-compliance by China and [with] United States-China agreements on prison labor imports and intellectual property rights; evaluate United States enforcement policies; and recommend what new measures the United States Government might take to strengthen our laws and enforcement activities and to encourage compliance by the Chinese.

WORLD TRADE ORGANIZATION COMPLIANCE.—The Commission shall review China’s record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.

MEDIA CONTROL.—The Commission shall evaluate Chinese government efforts to influence and control perceptions of the United States and its policies through the internet, the Chinese print and electronic media, and Chinese internal propaganda.

LIST OF WITNESSES, COMMUNICATIONS, AND PREPARED STATEMENTS

	Page
Carlson, Robert, Chairman of the Legislative and Trade Committee, National Farmers Union	105
Cassidy, Robert, Director, International Trade and Services, Collier Shannon Scott, LLC	57
Prepared statement	60
Craib, Anne, Director of International Trade and Government Affairs, Semiconductor Industry Association	140
Prepared statement	143
D'Amato, C. Richard, Vice Chairman	
Opening remarks of	5
Opening statement	5
Dorgan, Byron L., a U.S. Senator from the State of North Dakota	1
Freeman, Charles, Deputy Assistant U.S. Trade Representative	21
Prepared statement	24
Jochum, James, Assistant Secretary, Department of Commerce	10
Prepared statement	12
Kapp, Robert, President, U.S.-China Business Council	75
Prepared statement	77
Mulloy, Patrick, Hearing Co-Chair	
Opening remarks of	8, 49
Opening statement	9
Primosch, William, Director of International Business Policy, National Association of Manufacturers	126
Prepared statement	128
Reinsch, William A., Hearing Co-Chair	
Opening remarks of	73
Opening statement	74
Robinson, Roger W. Jr., Chairman	
Opening remarks of	1, 6
Opening statement	8
Schriver, Randall, Deputy Assistant Secretary, Department of State	17
Prepared statement	19
Sheikh, Patricia R., FAS Deputy Administrator	28
Prepared statement	30
Smith, Brad, Managing Director for International Relations, American Council of Life Insurers	170
Smith, Eric, President, International Intellectual Property Alliance	133
Prepared statement	135
Stewart, Terrance P., Managing Partner, Stewart and Stewart Law Offices	49
Prepared statement	52
Trainer, Timothy P., President, International AntiCounterfeiting Coalition, Inc	163
Trumka, Richard, Secretary-Treasurer, AFL-CIO	97
Vastine, Robert, President, Coalition of Service Industries	99
Prepared statement	101
Wroblewski, Ann, International Vice President, American Forest and Paper Association	146
Prepared statement	148