CHINESE STATE-OWNED AND STATE-CONTROLLED ENTERPRISES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY

REVIEW COMMISSION

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

FEBRUARY 15, 2012

Printed for use of the
United States-China Economic and Security Review Commission
Available via the World Wide Web: www.uscc.gov

UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2012

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Hon. DENNIS C. SHEA, *Chairman*
Hon. WILLIAM A. REINSCH, *Vice Chairman*

The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the "Consolidated Appropriations Resolution, 2003," Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the "Consolidated Appropriations Act, 2008," Public Law Nol. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December).

The Commission's full charter is available at www.uscc.gov.

March 1, 2012

The Honorable Daniel Inouye
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR INOUYE AND SPEAKER BOEHNER:

We are pleased to transmit the record of our February 15, 2012 public hearing on *"Chinese State-Owned and State-Controlled Enterprises."* The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners heard from the following witnesses: Representative Peter J. Visclosky (D-IN), Representative Sue Myrick (R-NC), Mr. Andrew Szamosszegi, Dr. Adam Hersh, Dr. Roselyn Hsueh, Mr. Timothy C. Brightbill, Dr. David F. Gordon, Mr. Paul T. Saulski, Ms. Elizabeth J. Drake, Dr. Derek Scissors, and Mr. Curtis J. Milhaupt. The subjects covered included the structure and nature of the Chinese government's ownership of the economy; the challenges U.S. companies face as they try to compete against Chinese state-owned and state-controlled enterprises in China, the United States, and third country markets; and policy options available to the United States for addressing challenges posed by Chinese state-owned enterprises.

We note that the full transcript of the hearing will be posted to the Commission's website when completed. The prepared statements and supporting documents submitted by the participants are now posted on the Commission's website at www.uscc.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2012 Annual Report that will be submitted to Congress in November 2012. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Jonathan Weston, at 202-624-1487 or jweston@uscc.gov.

Sincerely yours,

Dennis C. Shea
Chairman

William A. Reinsch
Vice Chairman

CONTENTS

WEDNESDAY, FEBRUARY 15, 2012

CHINESE STATE-OWNED AND STATE-CONTROLLED ENTERPRISES

PANEL II: THE COMPETITIVE CHALLENGES POSED BY CHINESE STATE-OWNED ENTERPRISES

PANEL III: POLICY OPTIONS FOR ADDRESSING CHINESE STATE-OWNED ENTERPRISES

CHINESE STATE-OWNED AND STATE-CONTROLLED ENTERPRISES

WEDNESDAY, FEBRUARY 15, 2012

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room 562 Dirksen Senate Office Building, Washington, D.C. at 9:00 a.m., Chairman Dennis C. Shea, and Commissioners Robin Cleveland and Michael R. Wessel (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Good morning, and welcome to the first economic hearing of the U.S.-China Economic and Security Review Commission annual 2012 cycle, and the first hearing that I've actually chaired. I want to thank you all for joining us today. We appreciate your attendance.

Our next hearing is scheduled for March 26, and will address China's civil and military nuclear programs and cyber issues. That will be followed by a hearing on April 19, which will examine Chinese-EU relations. If you're interested, you can go to www.uscc.gov to learn more about our hearings.

Today, we'll examine China's state-owned and state-controlled enterprises and explore the competitive challenges they may pose for U.S. businesses in the U.S. market and the global marketplace.

Chinese overseas investment is projected to reach as much as $500 billion by 2015, and if current trends continue, much of that investment will be made by Chinese SOEs.

The U.S.-China Business Council notes that state-owned and private Chinese companies are aggressively moving up the value chain to capture market share both in China and globally and are increasingly competitive in those markets.

While expansion is underway, Chinese mergers, acquisitions, and greenfield investments in the U.S. currently amount to just a fraction of foreign direct investment in the U.S. and Chinese outbound investment overall.

Chinese cumulative investment in the U.S. in 2011 was roughly 15.9 billion, and investments by SOEs appear to account for less than ten billion of that.

This means Chinese SOE investments in the U.S. amount to only five percent of U.S. FDI and accounts for just three percent of cumulative overall Chinese outbound investment.

The administration has recently taken note of this comparatively low level of Chinese investment and pressed forward with an effort to make clear the U.S. is open for business. Encouraging that investment in the U.S. by any party certainly makes economic sense.

So why this hearing, and why does there seem to be so much concern about the prospect of increased SOE investment? I think it comes down to concerns about transparency and accountability. A U.S.-China Business Council survey recently reflected that 96 percent of American companies surveyed believe Chinese SOEs receive tangible benefits and subsidies from the Chinese government, and two-thirds of those companies surveyed reported that they compete directly with those SOEs.

The Chamber of Commerce and Coalition of Service Industries reported last year that China and other countries provide generous regulatory favors and subsidies to their state-owned firms and that no adequate and effective international disciplines now exist to deal with that problem.

I think we will provide a useful service today if we can come to a better understanding at this hearing of just what is provided to SOEs that enhances their competitive position, and with a more complete picture, we may be in a better position to provide counsel to our congressional colleagues on how to improve agency oversight of these investments in the U.S. and assure our export agencies are using all tools and resources legally available to level the playing field.

I think the GE locomotive case comes to mind as a good example of how the U.S. exporters used our Export-Import Bank to compete with a Chinese company for Pakistan sales. I think that remains unresolved at this point.

U.S. Treasury Secretary Lael Brainard has reflected the administration's commitment to work through bilateral and multilateral channels to encourage China to dismantle financial controls that tend to channel cheaper credit to state-owned enterprises--one of the many concerns that U.S. companies express.

We're also involved at the OECD to establish a competitive neutrality framework. These efforts are welcome and necessary if we are to turn what is currently perceived as a threat - that is the hidden opaque operations and decision-making process of SOEs - into opportunity for trade and investment. We will ask our expert witnesses to shed light on these topics and provide their recommendations.

We appreciate you joining us today and look forward to your testimony. We'll hear from the experts on the panel, but, as I gather, members of Congress may come in and interrupt those proceedings. We apologize for that in advance in terms of disrupting the flow, but we look forward to hearing from both Mr. Visclosky and Ms. Myrick, and I'm also supposed to thank Senator Nelson and his staff for securing this room.

And with that, I'd like to turn the microphone over to my colleague Commissioner Wessel, who I have deep admiration for his depth of knowledge and his difference of opinion.

PREPARED STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

Good morning, and welcome to the first economic hearing of the U.S.-China Economic and Security Review Commission's 2012 Annual Report cycle. I want to thank you all for joining us today. We appreciate your attendance and we encourage you to attend our other public hearings throughout the year.

Our next hearing is scheduled for March 26th and will address China's civil and military nuclear programs and cyber issues. Our April 19th hearing will examine China-EU relations. More information about the Commission, its annual report, and its hearings is available on the Commission's website at www.USCC.gov.

At today's hearing, we will examine *"China's State-Owned and State-controlled Enterprises"* and explore the competitive challenges they may pose to U.S. businesses in the U.S. market and in the global market place. Chinese overseas investment is projected to reach as much as $500 billion by 2015, and if current trends continue, much of that investment will be made by Chinese SOEs. The U.S.-China Business Council notes that state-owned and private Chinese companies, "are aggressively moving up the value chain to capture market share both in China and globally, and are increasingly competitive in those markets."

But while expansion is underway, Chinese mergers, acquisitions and Greenfield investments in the U.S. currently amount to just a fraction of foreign direct investment in the U.S. and Chinese outbound investment overall. Chinese cumulative investment in the U.S. in 2011 was approximately $15.9 billion, and investments by Chinese SOEs appear to account for less than $10 billion of that. This means Chinese SOE investment in the U.S. amounts to only 5 percent of U.S. FDI, and accounts for just 3 percent of cumulative overall Chinese outbound investment. The Administration has recently taken note of this comparatively low level of Chinese investment in America and pressed forward with an effort to make clear that the U.S. is open to Chinese business. Encouraging investment in the U.S. by any party certainly makes economic sense. Chinese investment holds huge potential for creating American jobs and the Rhodium Group estimates that it has created as many as 10,000 to date despite its low value relative to U.S. FDI overall. It makes sense then that Chinese investment should be encouraged. So why this hearing and why does there seem to be so much concern about the prospect of increased SOE investment?

I think it comes down to concerns about transparency and accountability. I was interested by a recent U.S.-China Business Council survey that reflected 96 percent of American companies surveyed believe Chinese SOEs receive tangible benefits or subsidies from the Chinese government, and two-thirds of those companies surveyed reported that they compete directly with Chinese SOEs in China or elsewhere. The U.S. Chamber of Commerce and Coalition of Services Industries also reported last year that China and other countries provide generous regulatory favors and subsidies to their state-owned firms and that "no adequate and effective international disciplines now exist to deal with this problem."

I think we will provide a useful service if we can come to a better understanding at this hearing of just what is provided to SOEs that enhances their competitive position. With a more complete picture, we may be in a better positon to provide counsel to our Congressional colleagues on how to improve agency oversight of SOE investments in the U.S. and to assure our export agencies are using all tools and resources legally available to level the playing field in the global marketplace. The recent GE locomotive case comes to mind as a good example of how U.S. exporters used our Ex-Im Bank to compete with a Chinese company for Pakistan sales.

U.S. Treasury Undersecretary Lael Brainard has reflected the Administration's commitment to work through bilateral and multilateral channels to encourage China to "dismantle … financial controls that tend to channel cheaper credit to state-owned enterprises,"—just one of the benefits that U.S. companies state are of concern to them. The U.S. is also involved in Organization for Economic Cooperation negotiations to establish a "competitive neutrality" framework that would help to ensure a fair and level playing field for private and state-owned companies.

Those efforts are welcome and necessary if we are to turn what is currently perceived as a threat – that is the hidden operations and decision making processes of SOEs – into opportunity for trade and investment, and thousands more new American jobs.

Today, we will ask our expert witnesses to shed light on these topics and provide recommendations. Thank you for joining us. We look forward to hearing from each of you.

We will hear from experts on the first and second panel before lunch. We will adjourn for a lunch break at 12:45, after which the hearing will resume in this room at 1:45.

Before I turn the floor over to my co-Chair for this hearing, Commissioner Wessel, I would like to thank Representative Peter J. Visclosky of Indiana and Representative Sue Myrick of North Carolina for taking time out of their busy schedules to appear before the Commission today.

I would also like to thank Senator Ben Nelson and his staff for securing this room for us today.

OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

HEARING CO-CHAIR WESSEL: I also want to thank everyone for being here this morning, and my co-chair, Commissioner Cleveland, as well as our staff, for the team effort that has been put into putting this hearing together today.

We're appreciative of legal scholars and the academics who will appear before us today to discuss China's state-owned and state-controlled enterprises, the current status of those companies, their impact on China and on the U.S., the challenges they may pose, and what policy options may be appropriate for consideration regarding their activities.

But it's important to remember that while we will be hearing from legal scholars and academics, the challenges posed by China's SOEs are not theoretical or academic in their implications or impact. More than ten years after China's accession to the World Trade Organization, we have had more than enough experience to judge the operations of China's state-owned companies and to assess their current and future impact.

Some commentators like to suggest that the question is whether there should be an open investment climate or not? Their view is that all investment is good, no matter what its impact, and that investment should be supported no matter what the implications. Others may not share their view.

Today's hearing takes place in an important time. China's expected incoming president met with senior officials of the Obama administration yesterday and will continue his visit to the U.S. today and over the next several days, and in two weeks, administration officials will be meeting with their counterparts from the Trans-Pacific Partnership countries for nine days in Melbourne, Australia to try to hammer out significant portions of that trade agreement. Those events are linked.

Chinese leaders have been promoting their so-called "Going Out" strategy designed to encourage Chinese companies to invest overseas. Some of their designs have been met with objections here in Washington and elsewhere around the country. Vice President Xi's trip has been characterized in Beijing as an effort to deal with the "bilateral trust deficit." Vice President Xi has his work cut out for him, and the task will not be an easy one. China's SOEs have enormous market power, which is increasing. They are designed to facilitate the goals of China's Communist Party and to help achieve the goals of the country's 12th Five Year Plan. They are guided by the government rather than by market principles. They have virtually unlimited access to capital, much of it below market value or at no cost, and they are protected from foreign competition as a matter of national policy.

Negotiations in the TPP include a first-ever chapter on state-owned enterprises. Within the context of that agreement, the negotiators are seeking to address the activities of more than 2,000 Vietnamese SOEs. Coupled with that are the SOEs operating in Singapore and Malaysia, two other TPP participants.

But everyone involved in the talks is looking over their shoulders at China with an eye to how the final agreement will provide appropriate disciplines to address China's growing state sector. Will SOEs be required to follow commercial considerations in their activities? How will we inject more transparency into the system? Are there appropriate activities for SOEs in any country to be engaged in? What disciplines might be imposed and how might they be enforced?

Should there be different disciplines governing the activities of an SOE in their home market, in a third-country market, or in our market?

Today's hearing will help shed light not only on the bilateral challenges we face with China, but multilateral challenges as well, and how we might prepare for a future in which the state sector in China and elsewhere in Asia is growing in power and influence.

Thank you.

PREPARED STATEMENT OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

I want to thank my co-chair, Commissioner Cleveland, as well as our staff, for the team effort we've had in putting together today's hearing.

We are appreciative of the legal scholars and academics who will appear before us today to discuss China's State-Owned and State-Controlled Enterprises – the current status of those companies, their impact on China and on the U.S., the challenges they may pose, and what policy options may be appropriate for consideration regarding their activities.

But, it's important to remember that, while we will be hearing from legal scholars and academics, the challenges posed by China's SOEs are not theoretical or academic in their implications or impact. More than ten years after China's accession to the World Trade Organization, we have had more than enough experience to judge the operations of China's state-owned companies, and to assess their current and future impact.

Some commentators like to suggest that the question is whether there should be an open investment climate or not. Their view is that all investment is good, no matter what its impact and that investment should be supported no matter the implications. Others may not share their view.

Today's hearing takes place at an important time. China's expected incoming President met with senior officials of the Obama Administration yesterday and will be continue his visit to the U.S. today and over the next several days. And, in two weeks, Administration officials will be meeting with their counterparts from the Trans-Pacific Partnership countries for nine days in Melbourne, Australia, to try and hammer out significant portions of that trade agreement.

These events are linked. China's leaders have been promoting their so-called "going out" strategy, designed to encourage Chinese companies to invest overseas. Some of their designs have met with objections here in Washington and elsewhere around the country. Vice President Xi's trip has been characterized in Beijing as an effort to deal with the bilateral "trust deficit." Vice President Xi has his work cut out for him and the task will not be an easy one.

China's SOEs have enormous market power, which is increasing. They are designed to facilitate the goals of China's Communist Party and to help achieve the goals of the country's 12th Five Year Plan. They are guided by the government rather than by market principles, they have virtually unlimited access to capital, much of it below market value, or at no cost, and they are protected from foreign competition as a matter of national policy.

Negotiations in the TPP include a first-ever chapter on State-Owned Enterprises. Within the context of that agreement, the negotiators are seeking to address the activities of the more than 2,000 Vietnamese SOEs. Coupled with that are the SOEs operating in Singapore and Malaysia, two other TPP participants.

But, everyone involved in the talks is looking over their shoulders at China with an eye to how the final agreement will provide appropriate disciplines to address China's growing state sector.

Will SOEs be required to follow commercial considerations in their activities? How will we inject more transparency into the system? Are there appropriate activities for SOEs, in any country, to be engaged in? What disciplines might be imposed and how might they be enforced? Should there be different disciplines governing the activities of a SOE in their home market, in a third country market, or in our market?

Today's hearing will help shed light not only on the bilateral challenges we face with China, but multilateral challenges as well and how we might prepare for a future in which the state sector in China and elsewhere in Asia is growing in power and influence.

Panel I – Detailed Overview of the State-Owned Sector in China

HEARING CO-CHAIR CLEVELAND: Our first panel discussion will provide an overview of the SOE sector in China, assessing the evolving role of enterprises and their size relative to the private sector, their relationship to the Communist Party, and their place in implementing government policy.

We'll hear first from Mr. Andrew Szamosszegi, a principal at Capital Trade, who specializes in international economics and trade policy. He's consulted for U.S. and international clients on a wide range of economic and policy topics, and his experience covers industrial, high tech, and agricultural products with a regional focus on East Asia and Middle East economies.

He has appeared as a witness before, which we appreciate. He earned his degree from Harvard, studied at the University of Nagoya, and received his M.A. in Pacific International Affairs from the University of California at San Diego--a garden spot.

Also testifying on the first panel is Dr. Adam Hersh, an economist at the Center for American Progress.

Dr. Hersh's work focuses on economic growth, macroeconomics, international economics and the economies of China and other Asian nations, and I understand he has a unique expertise on town and village SOEs, researching them heavily.

Dr. Hersh earned his Ph.D. in economics from the University of Massachusetts. Prior to joining the Center, he taught macroeconomics and money and banking at the University of Massachusetts, was a visiting scholar at Shanghai University of Finance, and worked at a number of prestigious institutions.

We also look forward to hearing from Roselyn Hsueh. I'm sorry you didn't get a chance to eat your breakfast. Her research focuses heavily on international and comparative political economy of development.

She's recently published a book, China's Regulatory State: A New Strategy for Globalization, which examines China's integration into the international economy with a special focus on market reform and evolving government-business relations.

Dr. Hsueh has served as a post-doc fellow at the University of Southern California and as a Fulbright visiting scholar at the Institute of World Economics and Politics, part of the Chinese Academy of Social Sciences.

All written testimony can be found on the Commission's Web site. We'd really appreciate it if you could limit your opening statements to seven minutes so that we can ask you lots of questions.

And with that said, Mr. Szamosszegi, would you like to begin?

STATEMENT OF ANDREW SZAMOSSZEGI
PRINCIPAL, CAPITAL TRADE, INC., WASHINGTON, DC

MR. SZAMOSSZEGI: Good morning. I'm Andrew Szamosszegi, and I am a principal at Capital Trade Incorporated. I'm honored to appear today before the Commission on this extremely important and timely topic.

It's kind of ironic, given the tectonic shifts in the Chinese economy since the late 1970s, that we're here today talking about state-owned enterprises. At that time, China's economy had virtually no private enterprise, yet state-owned enterprises were of no concern to us. Today, the non-state sector in China accounts for half or more of economic output, yet state-owned enterprises are of great concern to us. And that concern is justified.

Although the private sector in China has grown dramatically since the late 1970s, it is a mistake to write off the state sector. In addition to the report I co-authored for the Commission and Dr. Hsueh's detailed study, a number of other works published during the past two years made the same general two points:

First, despite China's impressive economic reforms, the state sector remains a potent force. And second, the government and Communist Party in China continue to influence economic outcomes in important ways.

SOEs are ubiquitous in China's economy. They play a role in virtually all main economic sectors, either directly or indirectly through their subsidiaries and affiliated firms. Although the role of SOEs has been diluted somewhat in manufacturing sectors, they remain major players in several manufacturing industries.

Though of great interest, the share of GDP that is state-owned cannot be precisely calculated. However, based on reasonable assumptions, it appears that nearly 40 percent of GDP and 45 percent of non-agricultural GDP can be attributed to SOEs and SOE-controlled firms. If other forms of public enterprises are considered, it is not a far stretch to conclude that the share of GDP owned and controlled by the state in China is approximately 50 percent.

Now, true, this is much lower than it was ten years ago, and despite the decline in share, the state sector has been expanding in absolute terms by many other measures, such as output, assets and value added.

For some numbers, there are more than 100,000 state-owned enterprises in China. Approximately 117 of these are under the control of the central State-owned Assets Supervision and Administration Commission, known as SASAC. There are also a few hundred provincial, municipal, and county-level SASACs that own SOEs. The central SOEs are growing in importance relative to the non-central SOEs, but the latter remain economically important.

The current tilt of China's policy favors the state sector. SOEs and firms in promoted industries benefit from a wide range of subsidies and preferences. According to the Chinese think tank Unirule, these subsidies and preferences accounted for the entire profits of the state sector between 2001 and 2009. Absent subsidies, the real return on equity for SOEs would have been a minus 1.5 percent during that period.

Another study by the Hong Kong Institute for Monetary Research found that SOE profits would disappear if they had to pay market interest rates.

So, SOEs are big, they're growing, and they're favored by government policies. Yet, many compete in international markets and at home against privately-owned firms.

Do these SOEs respond to market forces? The incentive structure faced by SOEs suggests that even though they do respond to the market, they are ultimately beholden to the state. Their shares are owned by the government, usually through the central or local SASACs. The top executives of the top SOEs are actually chosen by the Central Organization Department of the Communist Party and are considered government officials. SASAC chooses the top executives at other central SOEs, as well as other high level executives within those firms.

SASAC grades the financial performance of its firms, but the Party's Organization Department also considers policy-related factors. Thus, the current incentive structure ensures that SOEs will respond not only to market forces but also to the goals of the state.

These goals are articulated in the five-year plans. The 12th Five Year Plan, unveiled in March 2011, proposes, among other things, the development of national champions in new industries. These include "strategic emerging industries," such as energy, health care, technology and new so-called "backbone" industries, such as biotechnology, new energy, high-end equipment manufacturing, clean energy vehicles and others.

National champions are to take the lead in developing these industries, and the government plans to channel capital resources accordingly.

It is generally understood that SOEs are in the best position to be national champions. Incentives encourage management to follow the government's plans, and subsidies ensure that SOEs succeed.

The state's influence over firms that it owns should be no surprise. The more interesting question in the long run is whether the state and Party will be able to influence purely private firms in China? Current indications are that they can to some degree. The state has been adept at using the leverage of market access in China to influence investment behavior, sourcing decisions, and technology transfer practices of foreign companies.

The CCP now welcomes domestic entrepreneurs as members and encourages private firms to join government-monitored associations. Private firms whose owners and managers are well connected to the Party and seek to expand in targeted industries have better access to capital and benefit from government subsidies as well. Though it lacks ownership in truly private firms, the government does try to reward those firms that follow its guidance.

So, should the United States be concerned about state-owned enterprises? The answer, for now, is yes. As opposed to the 1970s when China's state sector was inward looking, uncompetitive, and financially unimpressive, there is now a group of SOEs that is outward looking, competitive and financially strong. These firms are owned and controlled by a government that makes no secret of its industrial ambitions for China.

I'm sure that the other speakers today will give vivid examples of how such ambitions are already having dramatic effects on U.S. firms, U.S. workers, and international markets in general.

Thank you.

PREPARED STATEMENT OF ANDREW SZAMOSSZEGI PRINCIPAL, CAPITAL TRADE, INC., WASHINGTON, DC

Hearing on "Chinese State-Owned and State-Controlled Enterprises"

Wednesday, February15, 2012
Testimony before the U.S.-China Economic and Security Review Commission
Andrew Szamosszegi, Principal, Capital Trade, Inc.

It is my pleasure to appear today before the Commission on this important topic. My written remarks are based largely on the study I co-authored for the Commission with Cole Kyle of Capital Trade, Inc. Below, I respond to several questions put forth by the Commission prior to the hearing.

What is the scope of SOE activity in China?
Simply put, SOEs are ubiquitous. They play a role in virtually all main economic sectors. The direct role of SOEs has been diluted in manufacturing, but SOEs and their subsidiaries remain major players in several manufacturing industries. SOEs also play a prominent role in service sectors.

How much of the economy is state owned? State controlled?
How much of the economy is state-owned? There is no straight-forward answer because the level of detail in the public domain varies from sector to sector. To answer the question in a straight-forward way, you would want value added data by industry for all industries in the economy split between SOEs, non-SOEs, and enterprises with mixed ownership whose ultimate beneficial owner is an SOE. The so-called state-holding enterprises capture some of this last category, but not all of it, so a precise and dead-on accounting of the size of the state sector in China is not possible.

However, in our study for the Commission, we found that if one makes reasonable assumptions regarding the service sector and the construction sector, then the share of GDP accounted for by state-owned and controlled enterprises – which we term the visible state sector-- is nearly 40 percent and the share of non-agricultural GDP accounted for is approximately 45 percent. When you consider other forms of public enterprise such as government-owned township and village enterprises, urban collectives, and firms that are not registered as SOEs but are controlled by affiliates of one or more SOE, then it is not a far stretch to conclude that the share of GDP owned and controlled by the state is approximately 50 percent.

Has the state sector grown since 2001?

By most measures, the size of the state sector has expanded in absolute terms since 2001. However, the state sector has shrunk in importance due to the growth of the non-state sector. The one indicator where the state sector has declined in both absolute and relative terms is employment. The absolute number of SOEs has also declined.

How many SOEs are there? How about non-central SOEs?

There are approximately 117 SOEs under the control of the central State-owned Assets Supervision and Administration Commission. There are also a few hundred provincial, municipal, and county-level SASACs that own SOEs. According to the National Bureau of Statistics, there are more than 100,000 SOEs in total, the vast majority of which are not owned by the central SASAC. In general, the absolute number of central and local SOEs has been declining due to a number of factors, including the government's desire to consolidate SOEs, and the tendency of SOEs to increase their efficiency by adopting mixed forms of ownership, and the government's desire to embrace the large and let go of the small. But the central-SOEs have been expanding both in absolute terms and relative to non-central SOEs. It is also important to recognize that the prevalence of SOEs varies significantly across China's provinces.

What are the differences between SOEs and other entities with state "involvement" (i.e., state "invested" enterprises)?

State-owned enterprises are business entities established by central and local governments and whose supervisory officials are from the government. In official statistics, this category of firms includes only wholly state-funded firms. This definition excludes share-holding cooperative enterprises, joint-operation enterprises, limited liability corporations, and shareholding corporations whose majority shares are owned by the government, public organizations, or the SOEs themselves. A more encompassing category is "state-owned and state-holding enterprises." This category includes state-owned enterprises plus those firms whose majority shares belong to the government or other SOE. This latter category, also referred to as state-controlled enterprises (SCEs), can also include firms in which the state- or SOE-owned share is less than 50 percent, as long as the state or SOE has a controlling influence over management and operations.

Are the differences similar at the town and village enterprise level?

As with so much of China, the central structures are repeated at lower levels of government. Thus, at the local level, one will find SOEs that are wholly owned by the local SASAC. That SOE will have subsidiaries, some of which are registered as non-SOEs and may include some private capital. The term township and village enterprise (TVE) refers to the location of the enterprise rather than its ownership structure. During the early years of reform, TVEs supported by private capital grew rapidly in China's countryside, but since the mid 1990s TVEs owned by local governments have been ascendant.

Is any Chinese corporate entity truly "private" and a "market" player and not subject to government control?

Yes. There are numerous entities in China that are privately owned, respond to market-based incentives, and are not controlled by the government. However, these private entities operate in policy, regulatory and financial environments in which the state wields enormous clout and influence. As such, even private entities are influenced strongly by state goals and must respond accordingly. It is not hard to find prospectuses and corporate releases in which privately-owned companies trumpet their adherence to the state's plans for their industry. This circumstance is present to some degree in all economies, but it seems more prevalent in China due to the government's institutionalized planning activities and greater economic involvement.

In addition, the CCP now allows private entrepreneurs to join the Party and has other means of co-opting or influencing private firms, including access to capital. The web of state control does not prevent private firms from responding freely to market forces, but it does create an environment that encourages fealty to government development plants.

What kinds of government support do SOEs receive?

There are number of different types of subsidies conferred upon SOEs. These include programs where the benefit is relatively straight forward, such as grants, capital injections, preferential loan rates from state-owned banks, and preferential tax rates that encourage favored activities. They also include programs in which the financial contribution and benefit are more subtle. Some examples of this include inputs provided at favorable prices, such as electricity provided by state-owned utilities and steel provided by government-owned steel mills; debt forgiveness provided to SOEs that are technically bankrupt; and better access to capital relative to non-SOEs.

The subsidy rates calculated in countervailing duty investigations offer some guidance as to the extent of subsidization in China, but these rates are company-specific and cannot be applied to the SOE sector as a whole. However, subsidies and preferences afforded to SOEs are significant. According to the Chinese Think Tank Unirule, these subsidies and preferences account for the entire profits of the state-owned sector from 2001 to 2009. Absent subsidies the real return on equity of SOEs would have been minus 1.5 percent. Similarly, a study by the Hong Kong Institute for Monetary Research, cited in *The Economist*, found that SOE profits would disappear if they had to pay a market interest rate.

Can SOEs be considered to be "commercial" and, if so, in what respects?

SOEs certainly seek to earn profits, though profits are probably more important to some SOEs than to others. SASAC, at least in theory, now judges management performance on the basis of financial performance. Thus, there are incentives in place to encourage commercial behavior. On the other hand, SOE managers are also judged by the CCP's Organizations Department. This aspect of their review is more likely to include an assessment of how well the SOE is achieving the goals of the state as laid out in the overarching five-year plan and industry-specific development plans. This more political assessment of management performance may not matter if the financial objectives of the SOE do not work at crosscurrents to the goals of the state. But commercial behavior is not likely to prevail when the financial objective come into conflict with the goals of the state.

Do they pay dividends? Taxes? To whom?

Although the central SASAC is entitled to dividends from the central-SOEs it controls, it has not always received them. Dividend payments to the central SASAC have been rising and averaged 3.8 percent of profits in 2010. In addition, there are other SOEs under the purview of government ministries. Those SOEs typically pay dividends to the ministries if they pay them at all. There is a move to have these ministry supervised SOEs also pay dividends to the central SASAC. SOEs owned by subnational SASACs and government agencies pay dividends to those entities if they pay dividends at all. It is believed that the subnational SOEs pay less than the central SOEs. Dividends do not necessarily make it into the national budget, but are instead recycled into SOEs.

SOEs are responsible for paying value added taxes, the enterprise income tax, and other taxes. SOEs have been subject to the enterprise income tax since 1994 and the taxes paid by SOEs are considered budgeted revenue. Sub-national SOEs also are subject to the enterprise income tax.

How does the current five-year plan integrate SOEs and other Chinese firms into achieving the objectives of the state?
China's five-year plans provide a national "blueprint" for industrial development. They serve as economic and industrial instructions for planning agencies, local and provincial governments, banks, and state-owned enterprises. However, these entities are not always mentioned explicitly.

The 10th Five Year Plan for National Economic and Social Development, covering the period from 2001-2005, called for "energetically optimizing and improving [the] industrial sector" by enhancing traditional industries with new technologies and intensifying construction of transportation, energy, and other infrastructure facilities. After the successful implementation of the 10th Five Year Plan, the government was confronted with overcapacity in several key industries such as steel and chemicals. The subsequent 11th Five Year Plan, covering the years 2006-2010, focused on consolidation of capacity, along with the creation of new, high-efficiency facilities that can compete on a global scale. The result was an unbalanced economy heavily dependent on exports and investment. The 12th Five Year Plan, unveiled in March of 2011, focuses on "rebalancing" the economy through a greater emphasis on consumption.

In addition to this focus on rebalancing, the 12th 5YP has an ambitious emphasis on "Strategic Emerging Industries" such as energy, health care, and technology. The government aims to create new "backbone" industries, such as biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next generation IT. "National champions" are to take the lead in developing these industries. The plan states that the government must "{c}hannel state capital into industries pertinent to national security and the economy through discretionary and rational capital injection or withdrawal." Clearly, SOEs have an important role to play in this transformation of China's industrial structure.

Based on the overall plan, industry-specific five year plans are then formulated. These plans can be vague with respect to the anticipated role for SOEs. The plans generally emphasize favored industrial sectors. Five year plans are then formulated at the provincial level. These plans mirror the national plans but are tailored to the needs of a specific province. These plans will sometimes mention “key” enterprises in favored industrial sectors. Specific requirements about state-ownership are not often listed. However, often times “key” enterprises are state-owned.

It does not matter that the 12th Five-Year Plan does not mention SOEs explicitly with regards to key development projects and industry goals; the SOEs are already dominant in most of the industries which are mentioned in the plan. Moreover, in cases where projects require large capital expenditures, SOEs are in the best position to make such investments.

A review of a partial translation of the 12th Five-year Plan indicates SOEs will be affected by efforts to:

- Improve the services industries in China, many of which are currently dominated by SOEs;
- Support the old industrial base in Northeast China;
- Improve income distribution;
- Optimize investment structure;
- Channel investments into industries considered important to national security and the economy;
- Develop national champions and Chinese brands;
- Develop strategic emerging sectors;
- Implement industry innovation projects;
- Reform energy production.

Just to give an example of how this process might work, take the hotel sector. Over the past decade or so, SOEs have decided that they needed to own hotels. SASAC decided that these were non-core investments and in 2010 ordered SOEs not focused on tourism to exit the hotel business within five years. The hotels are being transferred, sometimes free of charge, to other SOEs like the China National Travel Services (HK) Group.

Does the CCP choose or influence the choice of directors and top management of SOEs?

The CCP does choose and influence the choice of directors and top management at SOEs. The Central Organizations Department of the CCP (“COD”) chooses the top three positions in the most prominent central SOEs. An analysis by Pei Minxin published in 2006 found that the CCP had appointed four-fifths of the chief executives at SOEs and more than half of all senior executives.

The importance of the COD is hard to overstate. China scholar Tony Saich of Harvard's Kennedy School describes the COD as follows:

> The Central Organization Department and its affiliates play a crucial role in maintaining discipline and adherence to the party through their control over members' personnel files, their evaluation of performance and recommendation for promotion. Basically, the Department oversees the CCP's *nomenklatura* appointments; these cover all senior military appointments, senior judicial appointees, heads of major state-owned enterprises, top university presidents such as Beijing and Tsingshua, the editors of key party publications and other media, provincial leaders and directors of think-tanks. Not surprisingly it becomes the turf for numerous battles between different factions and groupings in the party. Its influence is pervasive and party members bend over backwards to please and flatter the staff. One senior retired official told me that the CCP really only needs two agencies – the organization department and the propaganda department. He should know as he had headed both of them at different times.

In other SOEs the top three positions and other high level posts are filled by SASAC. But the COD plays a prominent role here as well. A source for our study who was also a high-ranking member of the personnel department of the Ministry of Science and Technology stated in an interview that it is still the COD that wields the real power behind the scenes for major personnel appointments at every stratum of Chinese society.

Are SOEs in the United States and other foreign markets primarily expected to turn a profit or to gain market share or to pursue other non-commercial goals?

All SOEs should not be considered free market actors because the government of China still exercises a substantial degree of control. Profits are not unimportant, but it would be a mistake to view profit maximization as the primary motivator of outward FDI by SOEs.

For the past five years, the government has encouraged its SOEs to "go out" into foreign markets. Foreign investments by Chinese SOEs are not a new phenomenon, but they are more prevalent now than ever before.

SOEs are pursuing both market oriented and state goals. Clearly, there has been a policy encouraging SOEs to buy into resource producing entities in foreign markets. In these cases, profits clearly take a back seat to the state objective of securing resources that the government thinks China needs. The government is also pursuing other strategies, such as the famous brands and indigenous innovation policies, which encourage foreign investments for reasons other than short-term profitability.

SOEs generally seek to make money while meeting the state's policy objectives. State policy may dictate certain types of investments and SOEs will consider profitability when choosing among these investment options. Certainly, increasing market share for Chinese branded products is an objective of the famous brands policy, and some SOEs that invest abroad my seek to gain market share. State capital is likely to be more tolerant than private capital of strategies that maximize market share at the expense of profitability.

In a recent essay Li Zhaoxi described China's "go global" policy as a combination of national goals and company objectives. Li's opinion should be interpreted as reflecting the policy tilt of China's government as he is the senior research fellow and deputy director of the Enterprise Research Institute of the State Council's Development Research Center.

According to Li, government encouragement of outward investment has three primary goals:

- securing natural resources, especially energy and raw materials;
- contributing to China's economic adjustment by eliminating excess supply, promoting capital accumulation, and accelerating technological innovation; and
- improving international competitiveness by establishing overseas distribution networks, developing managerial talent, and promoting Chinese brands.

Thus, official support for overseas investments by Chinese firms is not simply an expression of pride in China's successful economic development over the past three decades or a natural outgrowth of China's globalization. For Beijing, the expansion of China's businesses is a means to achieve certain policy goals for China's economy. Because of China's size and its large economy, its efforts to achieve these goals are likely to have, and are already having, noticeable impacts in international markets.

What is the allocation of capital resources in China between

SOEs and "private" entrepreneurs? What is the cost of capital for each?

It is now conventional wisdom that SOEs have favorable access to capital in China. This means that they are able to get favorable interest rates from state-owned banks and interest free loans from local governments, and that they are able to borrow money when they are uncreditworthy. This favorable access is a sore point with private entrepreneurs who often have to borrow from outside normal channels because the state-owned banks that dominate China's landscape still favor their state-owned clients. In the past, state-owned banks have been reformed to make them behave less like financial utilities, but the general perception is that they remain beholden to the CCP and will behave like utilities when it suits the needs of the CCP. The state-owned banks are also a powerful tool for encouraging firms to pursue the activities specified in the five-year plans.

This is not to say that private firms cannot borrow money from state-owned banks. They can, especially if they are well connected.

The cost of capital for SOEs is lower on the debt side because Chinese firms have lower cost access to bank funds, but also because they have better access to equity markets through their subsidiaries. A study of firm finance covering 2000 to 2007 found an interest rate spread of 4.1 percentage points between the borrowing rates of SOEs and private firms. A more recent study pegged the gap at 3.1 percent. These results are particularly striking because the private firms were significantly more profitable than the SOEs.

Are SOEs first in line for direct subsidies on land, energy, infrastructure, and indirect subsidies in the form of low regulations or outright exemption on workers' rights, health, and safety and environmental protection?

SOEs are well placed for obtaining direct subsidies, indirect subsidies, and preferences. However, the state will also provide subsidies to privately owned firms that are investing in industries favored by the state. As far as outright exemptions on worker rights, health, safety, and environment, it is not clear that SOEs receive special treatment. For example, many of the firms who dominate the electronics supply chain and have been in the news lately are not SOEs.

HEARING CO-CHAIR CLEVELAND: Thank you.

Dr. Hersh.

STATEMENT OF DR. ADAM HERSH
ECONOMIST, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

DR. HERSH: Good morning, Commissioners. Thank you for inviting me to testify today. My name is Adam Hersh, and I am an economist at the Center for American Progress Action Fund.

You have asked me today to talk about the role of state-owned enterprises in the Chinese economy. More than 30 years since beginning economic reforms, China's fundamental economic institutions today are dramatically different than the system of central planning operating during the Mao era.

But despite sweeping reforms, government control over China's economy remains pervasive, including through direct ownership of virtually all of the formal financial system and over much of the economy's productive assets.

China's economic governance institutions are still evolving today. They are complex and opaque, and this has led to some common misconceptions about how China's economy works. Today I want to try to clarify three of those misconceptions.

First, Beijing does not control or command everything that happens in China's economy. Government involvement is extensive, but most of the action aimed at developing companies happens at the local government level. Local officials are China's real entrepreneurs. They command tremendous financial resources and are involved in key business decisions, and their efforts are directed at developing both government owned and private companies.

Second, distinctions between "private" and "government ownership" are often irrelevant in the context of China societies. The same institutions and strategies that allow local officials to develop successful companies can readily be directed at private companies or government-owned companies alike. There are often interlocking relationships between family members, friends, colleagues, or even the same individual serving in key government and business posts.

Third, China's economic success is not due exclusively to cheating on international economic agreements. Many of the development strategies pursued in China make a lot of economic sense.

These include: policies to solve market failures that hold back investments in new factories and technologies; extensive investments in 21st century education and infrastructure to make workers and businesses more productive; and commitment to high employment macroeconomic policies that help develop a middle class in China who can provide deeper markets for businesses there.

To be sure, U.S. policymakers must take strong action against violations of international economic agreements and practices that give Chinese companies unfair advantages, including violations of worker rights and environmental rights. But China's successes also offer lessons that policymakers can apply today here in the United States. We have the power if we so choose to use it and these policies are consistent with American economic principles and America's own past policy practices.

My written testimony submitted for the record provides much greater detail, but let me begin by explaining how local government industrial policy works in China.

Local government officials wield substantial power and autonomy, and they have control over a vast supply of resources to support economic development.

The industrial system that local governments inherited is best seen through the lens of township and village enterprises, or TVEs. These TVEs evolved out of production brigades in the Mao-era agricultural collectives, though the basic structure of industrial policy of local governments supporting TVEs also pertains to local governments throughout different jurisdictions in China.

Economic reforms greatly transformed both the incentives and the resources available to local government officials to conduct industrial development policy. In a relatively short period of time, TVEs transformed from economically backward, undercapitalized, low technology enterprises into highly efficient and globally competitive companies. By the mid-1990s, they accounted for 40 percent of all China's exports.

Fiscal decentralization reforms let local officials keep and have discretion over certain taxes and fees collected from business and industrial activities rather than remit these taxes collected to higher-level government.

This arrangement created a virtuous cycle of incentives for officials: the more they worked to develop local industry and business, the more tax revenue they could collect from it, and then the more they could reinvest those revenues back into further developing industries.

At the same time, fierce competition in domestic and export markets among the multitudes of local governments pursuing their own individual development strategies helped keep the efficiencies of these local-government-involved enterprises in check, as did incentives for advancement in political careers within China, which are premised on hitting growth and export targets.

Officials were not just funneling production subsidies to inefficient companies. Thirty years of subsidizing inefficient companies does not create China-levels of economic growth. Local officials were underwriting costs and risks of developing new products and business practices, the costs and risks of entering new markets, and adopting more advanced technologies. These difficulties in development are commonly subject to what economists call "market failures" that impede investment and growth.

Rather than looking at ownership classifications, it's more instructive to look at where sources of financing for investment come from in China. Financial resources that local governments command far exceed those used by higher-level governments to support state-owned enterprises--primarily bank loans and direct transfers from the state budget. You can see this in Figure 1 of my testimony submitted. They also far exceed financing from foreign and private sources.

Under this system, TVEs developed rapidly and grew to account for a substantial share of exports and industrial production in China's economy.

By the mid-1990s, they were the lion's share of China's industrial economy. Then corporate governance reform happened. After that, it's difficult to trace the lines between government ownership and industrial policy, but what remained after corporate governance reform are the institutions that allowed local governments' intervention into industrial development.

Many of the things China's successful local governments do we also do in the United States, though we do it through different means, and the things that we do seem to have waning policy support in recent years.

To compete with China, the United States must enforce the rules of trade and high social standards, but we must also recommit to our own investments in building the blocks of a high growth and productive economy.

Thank you.

PREPARED STATEMENT OF DR. ADAM HERSH
ECONOMIST, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

Testimony before the U.S.-China Economic and Security Review Commission on "Chinese State-Owned and State-Controlled Enterprises"

Adam S. Hersh
Economist, Center for American Progress
February 15, 2012

Introduction

Good morning and thank you for inviting me to testify today. My name is Adam Hersh and I am an Economist at the Center for American Progress Action Fund.

You have asked me to talk about the role of state-owned enterprises in China's economy. More than 30 years since beginning economic reform, China's fundamental economic institutions today are dramatically different than the system of central planning operating during the Mao era. But despite sweeping reforms, government control over China's economy remains pervasive, including through direct ownership of virtually all of the formal financial system and much of the economy's productive assets.

The still evolving nexus of political and legal institutions, corporate structures, and economic relationships in China resulting from these reforms are complex and opaque. This has led to several common misconceptions about how China's economy works. Today I will try to clarify three.

First, Beijing neither controls nor coordinates everything in the Chinese economy. While government involvement in China's economy is extensive, most of the action aimed at developing individual companies happens at the local government level. Local officials make their own decisions in their own interests, often without the knowledge or support of Beijing. Local officials are integral to many of the entrepreneurial decisions that have led to China's remarkable economic success. The investment resources under local government control vastly exceed those used by the central government to support its own state-owned enterprises as well as private sources of financing.

Second, there is often no clear distinction between "privately owned" and "government-owned" enterprises in terms of government support—national, provincial or local—for economic development. Corporate governance reforms beginning in the mid-1990s transformed many once distinctly government-owned companies into an array of seemingly private, shareholding, or joint venture ownership forms. But the various government institutions that support the development of government-owned companies are just as readily applied to other ownership forms, as well. There is often a revolving door between top leadership in business and key government economic positions. And beyond this system of local government-led industrial policy, Communist Party infrastructure is expanding within private firms even as business leaders are expanding their reach within the Communist Party hierarchy.

Third, China's economic success is not due exclusively to cheating on international economic agreements. Many of China's development strategies make profound economic sense for building a productive and competitive economy. These include:

- Solving market failures common to all economies that create disincentives for private investments in factories, scientific research and development, and development of new markets and products
- Regulating the financial structure to supply capital for productive investments in the manufacturing sector
- Dedicating to public investments in 21st century education and infrastructure that make workers and businesses more productive
- Committing to employment-targeted macroeconomic policies that promote development of a middle class—and deepening of markets for businesses.

To be sure, U.S. policymakers must take strong action to investigate and remediate China's economic policies that violate international agreements or give Chinese companies unfair advantages—including violations of worker rights and environmental rights. But there are also clear lessons in China's economic success that U.S. policymakers can apply here in United States. U.S. policymakers also have the power to pursue these economic strategies today—if we so choose. What's more, these policies are consistent with American economic principles and America's own economic history.

But let me begin with the importance of local governments in China's economy today and going back several decades.

Origins and powers of local government industrial policy
Local government officials occupy a key position within China's economic structure giving them considerable power over economic affairs, finance, productive industry, and the everyday affairs

of people under their jurisdiction. The structure of state power in Chinese society is much different than in the United States. A long-time U.S. diplomat and China hand explained the distinction to me this way: “In the United States, you can do whatever you want unless the government says you can’t. In China, you can only do what the government permits you to do.”

This social structure has profound consequences for how power is distributed within the economy and the ability of local government officials to exercise authority beyond just the property rights conveyed by direct ownership of productive assets. Economists call this kind of power “first-mover advantage,” and it endows local government officials with power in setting the terms of contracts for workers, for enterprise managers, for people who lease lands or assets from the government, and really, for all who are subject to the regulatory discretion of officials, including privately owned businesses. So even businesses not owned by the government must dance to the tune of government officials, to an extent.

But local governments do also own significant portions of China’s economy, and they also command tremendous financial resources that can be used for economic development purposes. Political and economic reforms that steered China away from the Mao-era centrally planned economy devolved considerable power and resources to local government entities. The system of local government-managed industrial policy that emerged can be seen most clearly in the experience of China’s rural township and village enterprises, or TVEs. The authority and autonomy of local governments I describe were not limited just to TVEs or rural governments—it was replicated in local governments throughout the country.

TVEs as an enterprise form evolved from pre-reform era rural agricultural collectives and were organized under the authority of local government officials. Prior to reform, rural industrial enterprises existed in modest concentrations under rural production brigades, though, like most of the Mao-era economy, were typically highly inefficient and under-capitalized with antiquated technology. Reforms vastly transformed the incentives and opportunities for local governments to pursue industrial development. In a relatively short period of time, these companies developed a tremendous economic importance. In the 1980s, TVEs accounted for 30 percent of China’s growth in manufacturing and service sectors.[1] By the mid-1990s, literally millions of TVEs accounted for a combined 40 percent of China's total exports.[2] Economic analyses find that these TVEs achieved levels of efficiency that rivaled or surpassed privately owned and even foreign-invested companies.[3]

In the late 1990s and early 2000s TVEs and other local government owned enterprises underwent corporate governance reforms that resulted in a proliferation of ownership forms ranging from continued government ownership, to worker-owned cooperatives, to ostensibly private and foreign-invested companies. Although legal ownership status for many of these companies may have changed, the relationships and channels of influence between local governments and industry remain, including through the supply of capital for investment. Local government officials often concurrently serve as government executives, party secretaries, and directors of local enterprises.[4] In a 2002 nationally representative survey of local government leaders, 39 percent of party secretaries surveyed and 38 percent of village heads reported previous experience as enterprise managers; in half of localities either one or the other brought such experience into governance.[5] But officials also exercised power with a scope well beyond industry "over almost all aspects of social, political, and economic life" in local communities, according to World Bank Chief Economist Justin Lin and co-authors.[6] Little takes place in local economies without the explicit or tacit blessing of local officials.

Investment in China, under all property ownership classifications, is subject to extensive state influence through regulatory channels and through control of the financial system. Despite emergence of new ownership forms and private property rights, the extent of state influence over investment can be seen in persistent patterns of investment over time. Economist Thomas Rawski observes that even late into the economic reform process, China's investment cycles have not changed substantially from those seen under the centrally planned

[1] Lin, Justin Yifu, Fang Cai, and Zhou Li. 2003. The China Miracle: Development Strategy and Economic Reform. Hong Kong: Chinese University Press. P. 200.
[2] He, Kang. 2006. *Chinas Township and Village Enterprises*. Beijing: Foreign Language Press.
[3] Fu, Xiaolan, and V.N. Balasubramanyam. 2003. "Township and Village Enterprises in China." *Journal of Development Studies*. Vol. 39, no. 4, pp. 27-46.
[4] Whiting, Susan. 2001. *Power and Wealth in Modern China*. Cambridge: Cambridge University Press. P. 76
[5] Analysis of China Household Income Project Survey 2002.
[6] Lin, Justin Yifu, Fang Cai, and Zhou Li. 2003. The China Miracle: Development Strategy and Economic Reform. Hong Kong: Chinese University Press. P. 147.

economy. The consistent pattern indicates that the main determinants of investment—that is to say, government decision-making authority–also persisted through economic reforms.[7] MIT economist Huang Yasheng goes so far as to argue that the ability of local governments to raise funds for investment projects and to influence key production decisions "has been considerably enhanced" during the reform period.[8]

Professor Huang describes an extensive government structure for monitoring and overseeing fixed asset investments: "[investment] activities went through a government scrutiny process that required a bureaucratic paper trail."[9] And this bureaucratic trail is overwhelmingly local: in 1995, 70 percent of fixed asset investment was supervised under the jurisdiction of local governments; by 2008 local governments held jurisdiction over 83 percent of investment.[10] In 2008, only 6 percent of fixed investment occurred outside the jurisdiction of local or central governments.

How local governments fund economic development

Early reforms devolved much fiscal authority to local governments, altering the way they collect and remit taxes to higher levels of government. Prior to reform, local officials would remit collected taxes and then receive some revenue sharing allotment back from higher levels of government. This arrangement gave local officials little incentive to collect taxes or utilize revenues efficiently.

Fiscal reforms reversed this structure, in essence giving local officials a "property right" in the taxes they collect. In particular, taxes collected on industrial and commercial activities, and a range of miscellaneous fines and fees, would be retained at the local level as "extrabudgetary" revenues that local officials could use at their discretion. As much as two-thirds of all off-budget government revenues derived directly from the business activities of TVEs, though local governments also derived revenues from enterprises in other ownership categories.[11] In some provinces, extrabudgetary revenues

[7] Rawski, Thomas G. 2003. "Recent Developments in Chinas Labour Economy." Report pre-pared for ILO International Policy Group.
[8] Huang, Yasheng. 1996. *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era*. Pp. 223. Cambridge: Cambridge University Press.
[9] Huang, Yasheng. 2008. *Capitalism with Chinese Characteristics: Entrepreneurship and the State.* Pp. 20. Cambridge: Cambridge University Press.
[10] Analysis of China National Statistical Yearbook (*Zhongguo Tongji Nianjian*) 2011 data, Table 5-10.
[11] Lin, Justin Yifu, Fang Cai, and Zhou Li. 2003. The China Miracle: Development Strategy and Economic Reform. Hong Kong: Chinese University Press. P. 147.

accounted for as much as 60 percent of total fixed asset investment.[12]

To put the scale of local government resources in perspective, we can look at how sources of financing for fixed asset investment in China have evolved over time, from 1996 to 2009 (Figure 1).[13] First consider the primary sources of financial resources available to State Owned Enterprises under the control of Beijing and higher levels of government: domestic bank loans and funds allocated from the state budget. Over the past 15 years combined capital resources provided by the central government budget and domestic bank loans amounted ranged from 19 to 27 percent of total national investment. Today, state budget resources for investment represent a very small portion of overall investment, roughly 5 percent, down from nearly 30 percent in 1980. And not all domestic bank credit is used to support SOEs on a non-commercial basis. World Bank economists Robert Cull and Collin Xu find that firms receiving bank loans in China tend to be of higher productivity.[14] But the key point is that fully three-quarters to four-fifths of all fixed investment in China is not derived from capital sources over which the central government in Beijing holds direct control.

Foreign investment, to which many observers and analysts ascribe China's economic success, accounts for a relatively minor and diminishing portion of overall investment in China. In the time since China's WTO accession in December 2001, foreign investment averaged only 3.7 percent of national investment, and less than 2 percent in 2009. Even these figures overstate the impact of foreign investment. Much of what is recorded in statistics as foreign direct investment actually originates from domestic capital sources "round-tripped" through Hong Kong in order to receive preferential tax treatment. Estimates suggest one-quarter to one-half of all registered foreign direct investment actually originates from domestic sources.[15] Similarly, China's capital markets supply only a marginal share of total

[12] Huang, Yasheng. 1996. *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era*. Pp. 223. Cambridge: Cambridge University Press. P. 80.
[13] China's statistics define "fixed investment" as construction or purchase of fixed assets. Statistical changes in 1996 improved the accuracy of investment data and make inconsistent comparisons with earlier years.
[14] Cull, Robert, and Lixin Colin Xu. 2000. "Bureaucrats, State Banks, and the Efficiency of Credit Allocation: The Experience of Chinese State-Owned Enterprises." Journal of Comparative Economics. Vol. 28, no. 1, pp. 1-31; Cull, Robert, and Lixin Colin Xu. 2003. "Who gets credit? The behavior of bureaucrats and state banks in allocating credit to Chinese state-owned enterprises." *Journal of Development Economics.* Vol. 71, no. 2, pp. 533-559.
[15] Xiao, Geng. 2004. "Round-Tripping Foreign Direct Investment and the Peoples Republic of China." *Asian Development Bank Institute Research Paper Series No.58*. Tokyo: ADBI;

investment, on average less than 3 percent annually since WTO accession.

The vast majority of resources for investment seen in Figure 1 fall into the all-encompassing “other” category and is overwhelmingly the largest source of funds for investment in China. This amalgam includes (a) extrabudgetary revenues and other resources provided by local governments, (b) retained earnings of firms, and (c) funds raised through private finance. Private finance occurs mainly through informal, unregulated channels also sometimes called the “curb market.” Although research suggests informal finance is widespread, it is concentrated in relatively small-scale, low productivity entities. In the words of Professor Huang, truly private entrepreneurship is “a poor man’s affair” in China.[16] Moreover, much informal finance is not used for business investment, but rather for household consumption purposes or to finance migration or weddings.

Overall, “other” sources of funds climbed from 66 percent of total investment in 1996 to 77 percent in 2009. The “other” category is not exclusive to extrabudgetary revenues of local governments. Depending on the year, roughly half of “other” funds for investment can be attributed to extrabudgetary revenues—still considerably larger than any other single source of investment financing in China. Though it is not possible to pinpoint with accuracy the remaining contributing sources of funds to this category, it is clear that within this category are other sources under the domain of local government officials, including retained earnings of firms under local control and the forced savings of workers who are routinely required to post “employment performance bonds,” putting substantial capital at the disposal of firm management as a condition of securing a job. Thus, the overwhelming majority of funds for fixed asset investment in China are under the control of local governments.

More recently, under China’s 2009 and 2010 fiscal and monetary stimulus plan, local governments also borrowed substantial sums for investment from banks through what are called local government financing platforms. We are still learning many of the details of how this financial instrument worked and the scale of its use. But, in short, local governments created

[16] Huang, Yasheng. 2008. *Capitalism with Chinese Characteristics: Entrepreneurship and the State.* Pp. 20. Cambridge: Cambridge University Press. p. 68. Tsaui, Kellee S. 2002. *Back-Alley Banking: Private Entrepreneurs in China.* Cornell University Press.

investment companies that borrowed money from banks and used this capital for local investment projects. In theory, this borrowing would be accounted for under the domestic bank loans category presented in Figure 1. Use of this new financing vehicle does not change the story of how development strategies are financed in China, but serves to highlight the key roles played by local governments in development.

The entrepreneurial role of local government officials

The institutional arrangement of local government industrial policy financing established a virtuous circle of incentives for local officials. The more that the local economy developed, the more extra-budgetary revenues officials collected and could reinvest in economic development: extrabudgetary revenues and local industry developed hand-in-hand. The financial resources and economic assets under the authority of local officials certainly created ample opportunities for corruption, and anecdotal and journalistic accounts of corruption abound.

Yet local government-led industries also faced a significant disciplining effect in the form of rampant competition among the multitudes of localities pursuing development strategies—they competed against each other in domestic markets, and they competed against each other and high productivity companies from around the world in global export markets. Competition in markets helped drive local government enterprises to efficiency, but so did competition for political advancement, premised in large part on achieving economic and export growth targets set from above in the political hierarchy. In essence, the political advancement of local officials was linked to their entrepreneurial skills.[17]

Funneling large sums of financing to inefficient companies over extended periods of time does not yield sustained, rapid development over three decades by itself. Local officials must be doing something economically right with these funds. In addition to the incentives for growth and efficiency that evolved since 1978 through successive economic reforms, local governments directed funds toward economically efficient uses that expanded companies' and the overall economy's technological and productive capacity, and diversified production into new and increasingly more sophisticated manufacturing activities.

[17] Lu, Wen. 1997. "The Development of the Poperty Rights System Reform in TVEs." *Rural Economy in China*. No. 11. Huang, Yasheng. 1996. *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era*. Cambridge: Cambridge University Press.

Much recent economic research shows the critical importance of the manufacturing sector of an economy for accelerations and sustained strong levels of economic growth.[18] While manufacturing is important for growth and technological deepening, expansion of economic activities into new and more sophisticated areas are fraught with market failures, or what economists refer to more broadly as "coordination failures." These failures result when potentially profitable or welfare-enhancing opportunities exist, but are not taken by individuals or companies for a variety of reasons.[19]

In terms of growing new industries and adopting and developing new technologies—the foundations of economic growth—the key market failure problems tend to stem from (a) information spillovers, (b) difficulty in coordinating complementary investments needed to make some individual investments profitable, and (c) risks specific to start-up companies and small businesses that making financing difficult. It is costly and risky for firms to invest in discovering new products, new markets, new technologies, and new ways to do business. Once such an investment is made, the information about what can be profitable to do is readily available to other potential entrepreneurs. As a result, the discoverer of this information will not be able to recoup the benefits of making investments to discover this information. Economists have long known that such issues with information spillovers will lead to an economically inefficient undersupply of such investment, as well as research and development activities.

In the case of coordination problem (b), a potential investment opportunity may only be profitable if other complementary investments—public or private—are also made at the same time. For most firms, making the combined necessary investments is often beyond the means, scope of expertise, or risk appetite of an individual investor. Moreover, cooperation of multiple individual investors is difficult due to incomplete information among the parties and conflicts over how to divide the profits created from the complementing investments. Difficulty of small and new firms accessing investment capital in (c) is a problem faced by businesses in even advanced countries with highly

---

[18] Hausmann, Ricardo, Lant Pritchett, and Dani Rodrik. 2005. "Growth Accelerations." *Journal of Economic Growth.* Vol. 10, pp. 303-29; Johnson, Simon, Jonathan Ostry, and Arvind Subramanian. 2007. "The Prospectsfor Sustained Growth in Africa: Benchmarking the Constraints." *IMF Working Paper No. 07/52*; Jones, Benjamin and Benjamin Olken. 2005. "The Anatomy of Start-Stop Growth." *NBER Working Paper No. 11528*.
[19] Hausmann, Ricardo, and Dani Rodrik. 2003. "Economic Development as Self-Discovery." Journal of Development Economics. Vol. 72, December; Hausmann, Ricardo, and Dani Rodrik. 2006. "Doomed to Choose: Industrial Policy as Predicament." http://ksghome.harvard.edu/?drodrik/doomed.pdf.

developed financial systems.

Public interventions to resolve both coordination problems (a), (b), and (c) can be both general welfare and economic growth enhancing. Policies in the United States have served to remedy these challenges to growth through a variety of means: direct funding and tax subsidies for scientific research and development; coordinating development of new technologies through DARPA and SEMATECH; the Small Business Administration, the Small Business Innovation Research program, and the manufacturing extension program; efforts of state and municipal governments to develop regional economic clusters; and more. But in recent years, funding for such endeavors at the federal government level and cash-strapped states have waned, and come under repeated threats of budget cuts.[20]

Local governments in China have pursued policies similar in principle, though in a more aggressive, coordinated, and direct fashion through local government institutions. In addition to launching new enterprises, local governments used extrabudgetary revenues and other resources to finance investments in technological upgrading of enterprises and the costs of discovering new markets and expanding into new industries. And local government officials have directed this support to both government-owned and private-owned companies with a goal of promoting overall economic and export growth.

As we know, China's economic success since the early-1990s owes to its strong export-led growth strategy. The efficacy of local government-led development policies can be seen by analyzing how export development is statistically associated with the development financing available to local governments as compared to other modes of finance—domestic bank loans and central government budgets, foreign direct investment, and informal private finance—and other standard factors associated with export performance.[21] Econometric analysis shows that extrabudgetary revenues associated with local government industrial policy had a stronger effect on export development

[20] Hersh, Adam S. and Sarah Ayres. 2011. "Disinvesting in America." *Center for American Progress Issue Brief*. April 14. http://www.americanprogress.org/issues/2011/04/disinvesting_america.html; Hersh, Adam S. and Christian E. Weller. 2011. "Measuring Future U.S. Competitiveness." *Center for American Progress U.S. Productivity and Innovation Snapshot*. February 9. http://www.americanprogress.org/issues/2011/02/productivity_snapshot.html.

[21] Kletzer, Kenneth, and Pranab Bardhan 1987. "Credit Markets and Patterns of International Trade." *Journal of Development Economics*. Volume 27, Issues 1–2, pp. 57–70; Beck, Thorsten. 2003. "Financial Dependence and International Trade." *Review of International Economics*. Volume 11, Issue 2, pp. 296-316; Hersh, Adam S. 2011. *Why China Grew: Understanding the Financial Structure of Late Development*. Open Access Dissertations. Paper 334. http://scholarworks.umass.edu/open_access_dissertations/334.

than any other mode of finance, including foreign direct investment. For every one percent increase in extrabudgetary revenues in China's provinces, exports from that province increased 0.5 to 0.7 percent.

Lessons for the United States

The local government-led industrial strategy system I describe here has been remarkably successful and effective at delivering strong economic growth and steadily rising standard of living for Chinese citizens. While local government officials oversaw much successful microeconomic development, they did not do so on their own—they operated with an environment of supportive macroeconomic environment that allowed the seeds of local government investment to flourish. In particular, national level policies that reflect:

- Dedication to substantial public investments in 21st century education and public infrastructure systems that make for productive workers and businesses,
- And commitment to maintaining employment-targeted macroeconomic that have helped develop a middle class in China and provide deepening markets into which Chinese businesses can sell.

U.S. policymakers would not do in the same way many of the things that China's policymakers—at local and national levels of government—do to promote a strong and productive economy. But much of what China does, the United States does or can do through different means: investments in education, scientific research and development, infrastructure, and macroeconomic management for full-employment.

Thank you.

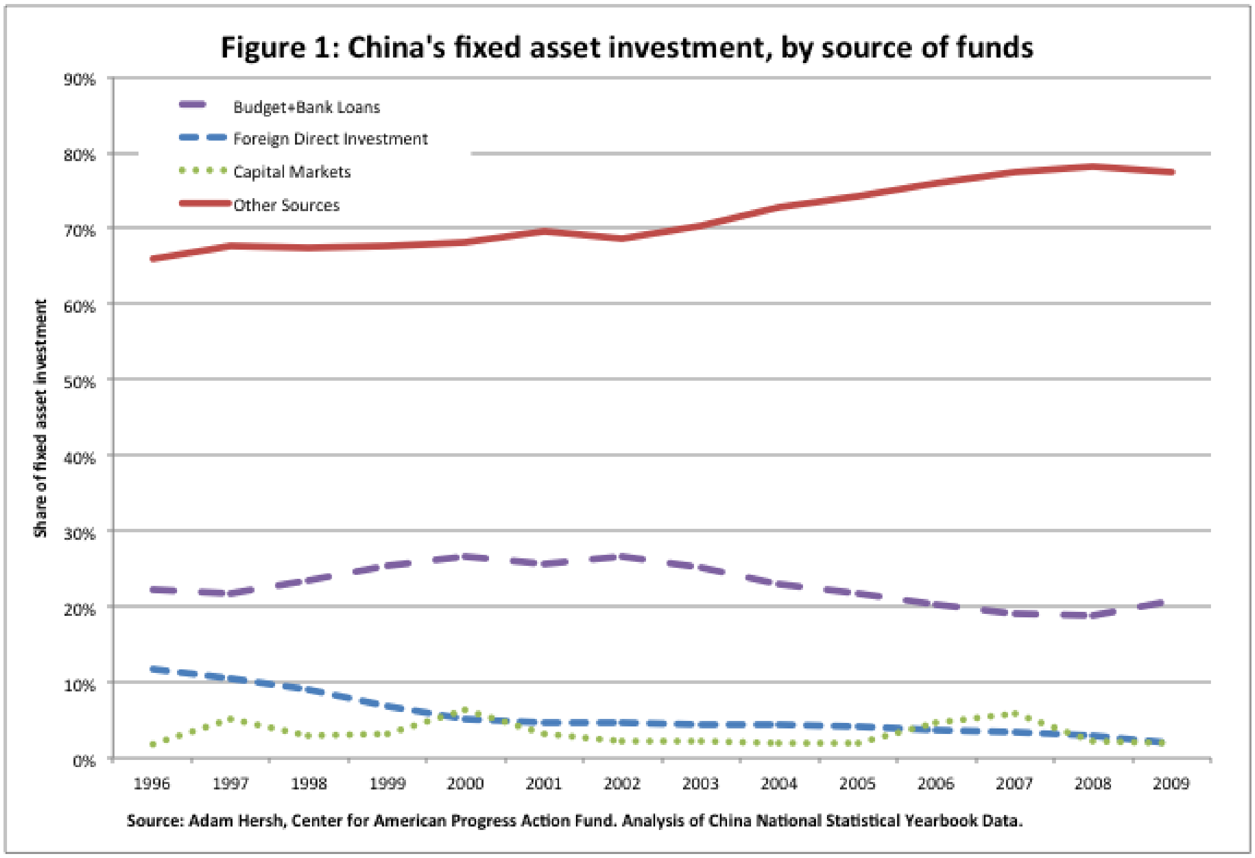
Figure 1: China's fixed asset investment, by source of funds
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Share of fixed asset investment
Budget+Bank Loans
Foreign Direct Investment
Capital Markets
Other Sources
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
Source: Adam Hersh, Center for American Progress Action Fund. Analysis of China National Statistical Yearbook Data.

HEARING CO-CHAIR CLEVELAND: Thank you.
Dr. Hsueh.

STATEMENT OF DR. ROSELYN HSUEH
ASSISTANT PROFESSOR, TEMPLE UNIVERSITY, PHILADELPHIA, PA

DR. HSUEH: Hi. Thank you so much for inviting me here today. My name is Roselyn Hsueh, political scientist at Temple University.

The People's Republic of China launched its Open Door Policy in 1978. Now, more than three decades later, a new model of capitalism has emerged. Market governance and economic engagement today depart from China's Communist past and its East Asian neighbors, which restricted rather than embraced foreign direct investment.

In an environment of more competition and foreign influence, the Chinese state has taken the lead in erecting market institutions and creating the rules of engagement. Its regulatory state deliberately combines liberal economic and state interventionist mechanisms in sector-specific ways.

The restructuring of strategic industries, with significant application for national security, contribution to the national technology base, and the competitiveness of other sectors in economy, exemplifies how the central state has used administrative streamlining to withdraw at the same time that it reasserts its influence in priority areas.

In those industrial sectors, the coordination capacity of the Chinese government has increased, but it does not regulate as a referee as commonly expected of independent regulators in liberal economies. Rather, the state complements the introduction of competition with the enhancement of bureaucratic coordination up and down the supply chain and strictly regulates market entry and exit, investment level, and the business scope of and competition between market players.

State-owned enterprises and private and foreign companies coexist, but the state remains the dominant owner and stakeholder of infrastructural assets and manages the adoption of foreign technology and initiation and implementation of indigenous technology. This dominant pattern of market governance manifests in strategic industries from telecommunications and banking to energy sectors and automobiles.

In contrast, less concerned about controlling products or services that do not have applications to national security and contribution to the national technology base, the Chinese government introduced competition, beginning in the 1980s, and decentralized market coordination to local governments and commerce bureaus throughout the 1990s.

Empowered with economic decision-making, decentralized actors, government and non-state alike, played key roles in market coordination and comprise the diversity of property rights in non-strategic industries.

Local governments and commerce bureaus approve market entry, which in many cases are completely liberalized. These decentralized authorities, including sector and business associations, act as economic stakeholders as opposed to dominant owners and managers in a fiercely competitive landscape.

Private enterprises, many of which restructured from town and village enterprises, were divested from state-owned companies, and foreign-invested ones compete fiercely. The business and politics of these markets are local, and companies have to contend with the vagaries of local politics, regulatory arbitrariness, and the lack of central will and regulatory capacity in enforcing macroeconomic and economy-wide rules. This dominant pattern of market governance is witnessed in industries ranging from textiles and consumer electronics to foodstuffs and paper.

So what are the economic, political and social implications of China's bifurcated strategy of market governance for the competitive performance of Chinese business and industry? What are the implications for global market competition?

Well, let us consider the telecommunications industry, an industry with high application for national security and significant contribution to the national technology base and the competitiveness of other sectors in the economy.

The introduction of market competition has attracted global players from AT&T to Motorola and MySpace to participate in the largest telecommunications market in the world, exposing Chinese industry to foreign technology and know-how. The sector-specific reregulation, which quickly followed, has fostered a vibrant Chinese communications industry in which value-added service providers, such as Yahoo and Google, compete, even while global operators are shut out of the basic services.

Foreign equipment makers from Ericsson and Nortel to Qualcomm also enjoy market share, thanks in part to the procurement of state-owned carriers which have embraced foreign technologies in addition to implementing indigenous ones.

Chinese companies now sell telecommunications equipment and provide services in global markets, particularly in developing countries in which Chinese government has strong diplomatic ties.

Politically, with complete control of telecommunications infrastructure and government ownership and management of communications networks, top leadership can mandate blackouts of Internet and mobile communications when politically sensitive and socially destabilizing issues arise and events occur.

At the same time, price-cutting is the dominant strategy between the fiercely competing state-owned carriers. This is not a sustainable strategy for the provision of quality services, which will limit the globalization potential of Chinese operators.

Moreover, industry insiders and market watchers have questioned the technical quality and marketability of China's indigenous networking technology, TD-SCDMA; they doubt global market adoption will ever occur. Strict regulation of strategic sectors has stifled domestic innovation and market viability of indigenous technologies, and in select IT subsectors, global companies have successfully protested against the enforcement of Chinese standards.

Additionally, aside from a few market standouts, such as Huawei and ZTE, most Chinese equipment makers compete in consumer telecommunications equipment and not the high tech, more value-added, networking subsectors.

On the other hand, among the nonstrategic industries, de facto and formal market liberalization and reregulation encouraged the emergence of domestic industry. Hypercompetition reigns, and many businesses emerge and quickly fail. Those that survive dominate local markets regulated by the local rules and local enforcement of economy-wide rules. Extensive market liberalization and non-sector-specific economy-wide and macroeconomic rules attract foreign direct investment, benefiting the domestic sector through technology and knowledge transfers.

Domestic companies have also benefited from subsidies targeted at strategic subsectors in nonstrategic industries such as technical textiles and geosynthetics, along the supply chain that contribute to the development of infrastructure, that have military applications, and that contribute to the competitiveness of other sectors and the rest of the economy.

In sectors and issue areas in which the central government has relinquished control, the lack of rules and lackluster enforcement of regulations has created problems that challenge China's political regime, including deficient regulatory capacity to enforce rules concerning human and animal health and safety and the environment.

This is prevalent in industrial sectors, such as food production and distribution and energy generation and production where the state had previously decentralized regulatory control.

China's new capitalism solves as well as creates governance problems as China simultaneously introduces markets and enhances state capacity to industrialize and modernize and maintain social stability and authoritarian rule.

Thank you.

PREPARED STATEMENT OF DR. ROSELYN HSUEH
ASSISTANT PROFESSOR, TEMPLE UNIVERISTY, PHILADELPHIA, PA

February 15, 2012
Roselyn Hsueh
Assistant Professor of Political Science
Temple University

Testimony before the U.S.-China Economic and Security Review Commission

CHINA'S REGULATORY REGIME AND NEW CAPITALISM

The People's Republic of China launched its Open Door Policy in 1978. More than three decades after the country's reintegration into the global economy, a new model of capitalism has emerged. Market governance and economic engagement today departs from China's Communist past and its East Asian neighbors, which restricted rather than embraced foreign direct investment (FDI). This new capitalism solves as well as creates governance problems as China simultaneously introduces markets and enhances state capacity to industrialize and modernize; and maintain social stability and authoritarian rule.

In an environment of more competition and foreign influence, the Chinese state has taken the lead in erecting market institutions and creating the rules of engagement. Its regulatory state deliberately combines liberal economic and state interventionist mechanisms in sector-specific ways. The restructuring of strategic industries, with significant application for national security, contribution to the national technology base, and the competitiveness of other sectors in the economy, exemplifies how the central state has used administrative streamlining, specifically the various rounds of downsizing of government bodies and personnel, including exercising control when and where it sees fit, to withdraw at the same time that it reasserts its influence in priority areas. In those industrial sectors, the coordination capacity of the Chinese government has increased but it does not regulate as a referee as commonly expected of independent regulators in liberal economies. Rather, the state complements the introduction of competition with the enhancement of bureaucratic coordination up and down the supply chain, and strictly regulates market entry and exit, investment level, and the business scope of and competition between market players. State-owned enterprises (SOEs) and private and foreign companies co-exist; but the state remains a dominant owner and shareholder of infrastructural assets and manages the adoption of foreign technology and initiation and implementation of indigenous technology. This dominant pattern of market governance manifests in strategic industries from telecommunications and banking to energy sectors and automobiles.

In contrast, less concerned about controlling products or services that do not have applications to national security and contribution to the national technology base, the Chinese government introduced competition beginning in the 1980s and decentralized market coordination to local governments and commerce bureaus throughout the 1990s. Empowered with economic decision-making, decentralized actors, government and nonstate alike, play key roles in market coordination and comprise the diversity of property rights. Local governments and commerce bureaus approve market entry, which in many cases are completely liberalized. These decentralized authorities, including sector and business associations, act as economic stakeholders as opposed to dominant owners and managers in a fiercely competitive landscape. Private enterprises, many of which restructured from town and village enterprises or divested from state-owned companies, and foreign-invested ones compete fiercely. The business and politics of these markets are local and companies have to contend with the vagaries of local politics, regulatory arbitrariness, and lack of central will and regulatory capacity in enforcing macroeconomic and economy-wide rules. This dominant pattern of market governance is witnessed in industries ranging from textiles and consumer electronics to foodstuffs and paper.

Various dynamics at different levels of government have emerged in the regulatory transformation entailed in China's bifurcated strategy of market reform. The administrative and ownership restructuring witnessed in different phases of liberalization and reregulation reveal the growing diversity in function and form of government agencies and quasi-state organizations from the center to the locality. In strategic industries, central ministries have a mandate but it does not mean that central bureaucrats always agree on actual policy details. In nonstrategic ones, provincial and local branches of central ministries wrestle for influence in regulatory enforcement and local rulemaking. In these contexts, actual details of regulatory and market restructuring and new and reformulated rules to enhance or relinquish central authority are often products of much protracted bureaucratic conflict or fierce bargaining between relevant political and economic stakeholders. The lists below summarize the sectoral variation in dominant patterns of market governance in China today.[1]

Market Governance in Strategic Industries

- Separation of enterprise from government bureaucracy; corporatization; business restructuring, and/ or creation of SOE groups (and public listing)
- Introduction of competition between SOEs and sometimes the nonstate sector
- Centralized bureaucracies make policy and regulate or delegate implementation to lower levels of government
- Sector-specific rules on ownership, investment level, and market entry (no private entry, domestic sector only, and/or foreign investment through joint ventures), product certification, and technical standards

Market Governance in Nonstrategic Industries

- Divestment of state assets to former managers, corporatization, and/or business restructuring (and public listing)
- Liberalization of market entry
- Vibrant private sector, comprising quasi-state–quasi-private firms and FDI
- Economy-wide rules on market entry, macro-economic policies, and local approval of market entry and licensure of business scope

ECONOMIC, SOCIAL, AND POLITICAL IMPLICATIONS

[1] Lists adapted from Roselyn Hsueh, *China's Regulatory State: A New Strategy for Globalization* (Cornell University Press, 2011).

What are the economic, political, and social implications of China's bifurcated strategy of market governance for the competitive performance of Chinese business and industry? What are the implications for global market competition? Let us consider the telecommunications industry, an industry with high application for national security and significant contribution to the national technology base and the competitiveness of other sectors in the economy. The introduction of market competition has attracted global players from AT&T to Motorola and MySpace to participate in the largest telecommunications market in the world, exposing Chinese industry to foreign technology and knowhow. The sector-specific reregulation, which quickly followed, has fostered a vibrant Chinese telecommunications industry in which value-added service providers, such as Yahoo and Google compete, even while global operators are shut out of basic services.

Foreign equipment makers from Ericsson and Nortel to Qualcomm also enjoy market share thanks in part to the procurement of state-owned carriers, which have embraced foreign technologies, in addition to implementing indigenous ones. Moreover, Chinese companies now sell telecommunications equipment and provide services in global markets, particularly in developing countries such as Iran and Nigeria, with which the Chinese government has strong diplomatic ties. Politically, with complete control of telecommunications infrastructure in government ownership and management of communications networks, top leadership can mandate blackouts of Internet and mobile communications in China proper and Tibet and Inner Mongolia when politically sensitive and socially destabilizing issues arise and events occur.

At the same time, price-cutting is the dominant strategy between the fiercely competing state-owned carriers; this is not a sustainable strategy for the provision of quality services, which will limit the globalization potential of Chinese operators. It remains to be seen whether sector specific reregulation to control information infrastructure and dissemination will exempt the Chinese Communist Party from the political effects of the global information revolution being witnessed in the Middle East with the Arab Spring. Developments thus far show that it is very possible to have freer markets and more authoritarian control. In the short term, the distinct path-dependent patterns of state control disincentivize bottom-up democratic mobilization and political reform from above. Moreover, industry insiders and market watchers have questioned the technical quality and marketability of China's indigenous networking technology, TD-SCDMA; they doubt global market adoption will ever occur. Strict regulation of strategic sectors has stifled domestic innovation and market viability of indigenous technologies; and in select Information Technology subsectors, global companies have successfully protested against the enforcement of Chinese standards. Additionally, aside from a few market standouts, such as Huawei and ZTE, most Chinese equipment makers compete in consumer telecommunications equipment and not the high tech, more value-added networking segments.

Among the nonstrategic industries, de facto and formal market liberalization and reregulation encouraged the emergence of domestic industry. Hypercompetition reigns; thus many businesses emerge and quickly fail. Those that survive dominate local markets regulated by local rules and local enforcement of economywide rules. Extensive market liberalization and non-sector-specific economy-wide and macroeconomic rules attract FDI, benefiting the domestic sector through technology and knowledge transfers. Domestic companies have also benefited from subsidies targeted at strategic subsectors in nonstrategic industries, such as technical textiles and geosynthetics, along the supply chain that contribute to the development of infrastructure, that have military applications, and that contribute to the competitiveness of other sectors and the rest of the economy.

In sectors and issue areas in which the central state has relinquished control, the lack of rules and lackluster enforcement of regulations have created economic, social, and political problems that challenge China's political regime. These problems include deficient regulatory capacity to enforce rules concerning human and animal health and safety and the environment. This is prevalent in industrial sectors, such as food production and distribution and energy generation, where the state had previously decentralized regulatory control.

Importantly, as the Chinese government has concentrated its macro- and micro-level measures on promoting industrial development, much of the dividends fall in the area of export growth. Many measures encourage manufactured exports at the expense of the service sector, depressing job growth and cramping spending power when wages are already low, thereby dampening domestic consumption. In the Eleventh Five-Year Plan issued in 2006, the Chinese government switched its focus to promoting indigenous production and domestic consumption, relying on administrative and macroeconomic measures to do so. But to the chagrin of its trade partners, the Chinese government has not increased the value of the renminbi to a satisfactory level. What is more, the central government's efforts to address the unintended consequences of China's development model never stray too far from its bifurcated strategy of reregulation.

For example, during the global economic slowdown, the Chinese government announced in 2008 an economic stimulus plan that allocated nearly USD 600 billion to infrastructure and social programs. Provincial governments followed suit with their own stimulus packages. Central and local stimulus plans, however, were not necessarily conceived in response to the financial crisis. The Eleventh Five-Year Plan (2006-2010) had already included many of the projects, and provincial governments revived previously defunct projects in the hopes difficult financial times would persuade Beijing to fund them. Beijing has paid special attention to strategic sectors, and left the rest of the economy to the localities.

TOWARD A CHINESE MODEL OF DEVELOPMENT

Notwithstanding the divergent patterns of market governance witnessed in China today, the most centrally coordinated sectors in the post-Mao era break from the ideal typical socialist system and the most liberalized depart from a liberal capitalist system. China in 2010 is a one-party dominant state that does not exercise ideologically driven control over its economy. Rather, it bases its control of the economy and markets on a strategic value logic, which varies by industrial sector. Its departure from Marxist-Leninism is exemplified in the de facto distribution of property rights across the political economy. While state-owned national champions in strategic industries receive preferential treatment from state financial and administrative bureaucracies, quasi-private and de facto private companies, including foreign ones, compete with one another in nonstrategic industries. Moreover, while bureaucratic coordination dominated Mao's China, today central bureaucracies preside over less than half of the economy. Decentralized market coordination dominates industries noncritical to national security, the national technology base, and the competitiveness of the rest of the economy.

As for the typical behavior of economic actors, even while some national and local state-owned enterprises enjoy soft budget constraints, many state-owned companies have instituted reforms to operate on a hard budget constraint, especially ones considered strategic by the government. Fierce competition to increase market share characterizes the economy; these are markets not constrained by a central plan. The typical economic phenomena are chaotic and saturated markets, and business cycle fluctuations, not chronic shortages and sellers' markets. Chinese entrepreneurs drive economic growth even while operating within deliberate patterns of market governance; they are eager to stay in business and not agitating for political reform. The most successful businesspeople are invited to serve as representatives of the local and national people's congresses. In the span of thirty years, China has transitioned away from a socialist economic system to a capitalist one, marked by bifurcation in market governance.

HEARING CO-CHAIR CLEVELAND: Thank you.

Commissioner Fiedler.

Panel I – Questions and Answers

COMMISSIONER FIEDLER: I have a couple of factual questions to start with. Does anybody know the amount of money that Chinese state enterprises have raised on the international markets, both worldwide and maybe particularly the United States, and if you don't have that sort of number, can you get it to us? Has anybody looked at that?

MR. SZAMOSSZEGI: I do not, and maybe it exists. I do not know of one source of where you can find all of that data, it would be possible to get that data simply by looking over the various transactions and those are recorded by various firms, but I just haven't seen it in one place on a worldwide basis.

COMMISSIONER FIEDLER: What I'm sort of getting to is an analysis of how much we, the Western capital markets, have supported the rise of national champions by providing capital to them. It's all publicly available information, and actually if nobody is tracking it, it shows me some problem in how we view these guys.

DR. HSUEH: In terms of quantitative measures, right now, I can't give you the numbers. I'd be happy to find the information for you, but I know that among the strategic industries, telecommunications and banking, for the international IPOs of the state-owned banks, as well as the state-owned carriers, they have, each time each of these carriers or banks IPOed, become the largest IPO for the particular moment in time.

COMMISSIONER FIEDLER: I think my point is that we're raising billions of dollars on their behalf, and that has policy implications, it seems to me.

Second question is, does anybody track the joint ventures that U.S. multinationals have with these 130 some odd state, the national champions, which is the other form of assistance that we're giving to the state enterprises?

DR. HERSH: Commissioner, I'll address your first question first. It's a complicated question to answer because changes in corporate governance organization within Chinese corporate structure may make it impossible to detect the values raised on international capital markets if a Chinese domestic firm incorporates offshore in Hong Kong.

In the available statistics of money raised on capital markets by Chinese companies reported from official statistics, it's relatively small compared to the overall investment in China's economy. In Figure 1 of the testimony I submitted, I show a graph of the various sources of investment, sources of funds for investment in China and capital markets in total.

Both those raised on domestic markets and raised on international markets average about only three percent of overall investment in the Chinese economy. Even though some of the big headline IPOs in recent years, particularly for listings of the Big Four banks, have been record-breaking in world markets, it is relatively small in the overall scale of investments in China's economy.

I'd be happy to provide you those figures again.

COMMISSIONER FIEDLER: Okay. I only have a minute so I want to ask a question I've asked in previous years and had less satisfactory answers to, and I will focus this on the economists, but, Dr. Hsueh, you can pitch in.

What do you call it, what is the best way--we describe our system as a capitalist system. They are no longer communist. They are no longer socialist. They are not really capitalist. What is an accurate appellation for the Chinese economy? State capitalism? Bureaucratic capitalism? Crony capitalism? What is the--what should we be calling it?

DR. HERSH: There's a substantial cottage industry within academics of what to call--

COMMISSIONER FIEDLER: What do you think?

DR. HERSH: --how to describe the Chinese economy and I don't think any of the labels that people come up with are sufficient for describing what is the relative role of state and market within the economy. All economies have a degree of state involvement and private involvement in economic activity.

It's a question of where power is distributed within the economic relationships of the economy. I had a former U.S. diplomat, China hand, and now a private businessman in China, explain to me this way: in the United States, the legal structure is set up such that we are free to do anything we want so long as the government does not prohibit it. In China, you can't do anything unless the government explicitly permits it. But I don't have a name for that.

DR. HSUEH: Because of the bifurcated market governance and distribution of property rights I talk about in my written statement and oral statement, I would characterize China's new capitalism as a bifurcated capitalism where you do see very distinct and very different patterns of market governance and distribution of property rights across industrial sectors, mainly the strategic and nonstrategic ones.

MR. SZAMOSSZEGI: I would agree that state capitalism is a useful moniker for what to call China, but I would also agree that in many cases, there's a lot more going on, and that simple terms like "state-guided capitalism" don't accurately capture everything that's going on in the economy.

COMMISSIONER FIEDLER: Thank you very much.

HEARING CO-CHAIR CLEVELAND: Thank you.

Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you all for being here today. Very interesting and helpful testimony. I quite frankly have hours of questions, but I know I'll be limited to five minutes. So let me see what I can jam in in that time, and if you can each respond quickly.

We seem to want to apply our own standard and own metric to what success is. Dr. Hersh, you talked about market failures. China is a non-market economy. Whatever you may want to call it in terms of state capitalism, et cetera, it seems that they put our system here to shame in terms of the revolving door between business and government.

How do you measure success? Is success measured by growth rates and employment, in which case, it seems to me China is not doing badly? If you look at those indicators here, maybe we're not doing as well as we'd like. You know, economics is not some, you know, there aren't immutable laws. We've been through Keynes, supply side, and many other things.

How should we view success in terms of the state sector? Dr. Hersh, if you want to start, and, please, quickly.

DR. HERSH: Thank you.

There's a large debate within economics about how we should measure the success of our economic activities within countries and as human beings on this planet. China has been very successful in some things. They've been very successful in raising living standards throughout the economy although that has happened in a very uneven way. People are seeing steadily rising living standards.

They've been very successful at expanding the range of economic activities in which the economy participates. They've been very successful at climbing up the ladder of technological sophistication to higher value-added processes within the production chain. They've been relatively unsuccessful in stamping out problems of corruption and inequality. They've been very unsuccessful in terms of delivering a sustainable quality of life within their country.

China's growth soon will be bumping against resource constraints from environmental degradation, particularly in the realm of management of water resources. So there's a mixture of successes and failures within China's model.

HEARING CO-CHAIR WESSEL: So if you were to give them a grade and the U.S. a grade, how would you grade each of us in terms of the indicators and the measures that you use? A through F.

DR. HERSH: A through F. It's a grade on more dimensions than that one scale A through F. So, in some things the United States is being successful; in some things China is being more successful. The trick is to find ways to move in both directions at the same time.

HEARING CO-CHAIR WESSEL: Okay. Well, when my kids were young, it also had the question of "plays well with others," but we'll leave that to another question.

Dr. Hsueh, can I ask you a question about how the system of approvals works? I think you know something about this in terms of SOEs versus private whatever you want to call non-SOEs. How does the government in terms of outward-bound investment deal with those type of questions?

DR. HSUEH: Outward-bound in terms of outward foreign direct investment?

HEARING CO-CHAIR WESSEL: Correct.

DR. HSUEH: Chinese investment.

HEARING CO-CHAIR WESSEL: For example, investing in the U.S., how does the government address, since they approve all outward bound investment--

DR. HSUEH: Right.

HEARING CO-CHAIR WESSEL: --no matter from what source--correct--how is that judged and what's the decision-making process?

DR. HSUEH: For the strategic industries, the Ministry of Commerce along with the sector-specific ministry in charge would be given the authority to approve the actual investment level of particular companies, and the actual approval will be dependent on which industry that the company is from, and so if it's a strategic industry, an industry that's important to the national government, then depending on the strategic concerns of the industry in question, approval could be more like a registration.

But if it's something that is considered very strategic to the government and involves national security concerns, political stability issues and so forth, then there would be a discretionary process that would have to take place. You know, for one of the companies I look at in my book, for some of those textile apparel companies, the Ministry of Commerce makes the approval, and it's basically a registration process, and they could be registered in different stock exchanges across the world.

They could invest in different countries in the world without much question, without the concern of the State Council and any other ministry. But if it's going to be Huawei or ZTE, in the strategic industries such as telecommunications, then there will be a discretionary process.

HEARING CO-CHAIR WESSEL: And that could go to the State Council?

DR. HSUEH: That could go to the State Council. In fact, for telecommunications, there's a State Council Office of Informationization, which would deal with questions such as--that would involve outward as well as inward FDI.

HEARING CO-CHAIR WESSEL: And that would cover no matter what the status of the entity making the investment, meaning that Huawei--

DR. HSUEH: Whether state-owned or not state-owned. So I would say that it really is about the--

HEARING CO-CHAIR WESSEL: The sector or--

DR. HSUEH: --the sector, the characteristics of the sector.

At the same time, there's a strong correlation between the characteristics of a sector and the type of property rights that you do see in those industries.

HEARING CO-CHAIR WESSEL: Understand. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you. Thank you all for coming and testifying. Very interesting.

I have a question I think mostly directed to Dr. Hsueh. I just returned from China and met with many, many entrepreneurs in the private sector really trying to make it not in the state-owned enterprise sector.

It seems to me, and I'd like a response to this, the SOE policy in China is hurting China more than anybody else. The capital misallocation, the capital going to inefficient industries, the stifling of private sector growth because of state extraction through state-owned banks, the lack of a financial sector that can actually pick the most productive uses of capital, you know.

So it seems to me that for those who are concerned about China being a competitor and really being a competitor in the future with the United States, they should be concerned about what happens if China actually lets its state-owned enterprises undergo real competition with its own private sector and undergo competition with foreign companies.

And, again, I'd like a reaction to that. I mean it just seems like if China hadn't misallocated so much capital to its state-owned enterprises and extracted so much from its private sector through the state-owned enterprise system, China would be growing at much faster rates.

DR. HSUEH: Uh-huh. I would emphasize that not all state-owned enterprises are made equal in China, and again, that has a lot to do with the bifurcation that I talked about, and so through several state sector restructuring efforts from the '90s to the 2000s, there have been several--four or five-- official explicit state restructuring reform efforts in the industries that the central government cares a lot about for strategic reasons.

For the different strategic goals I outlined, a lot of those state-owned enterprises have gone through mergers and acquisitions, corporatizations, and also divestment, as well, to make those state-owned enterprises now national champions, and so they are competitive players within China and sometimes even global players.

But they are also the other picture, and that describes a lot of the state-owned enterprises that you're referring to, the ones that are not in industries strategic to the central government, and so the governance, the regulatory governance, of those industries has been decentralized, and so the localities and the different authorities and localities are left to fend with those state-owned enterprises, and they also have gone through these different restructurings and mergers and acquisitions and divestment processes.

But depending on the locality we're talking about, some of these local governments do not have the efficiency or the know-how to deal with the restructuring process, and for local political motivations, some of them have not let go of state-owned enterprises the way that the central government with their strategic concerns has allowed for the reform of the national champions.

COMMISSIONER BLUMENTHAL: I guess my question is more if China actually was able to develop a financial sector that could actually allocate capital to businesses that are really competitive; wouldn't that just set off China's economy far more than it is today?

I mean isn't China undergoing some serious capital misallocation because of its SOE policy that, in fact, the private sector is suffering, and what is--if anyone has it--what is the cost of waste and inefficiency because bank loans are going to preferred SOEs and not going to the most efficient and productive companies in China? I mean there must be massive amounts of waste and inefficiency.

DR. HSUEH: A lot of the local--the allocations of banks at the provincial and municipal and town and village levels are taking place, the decision-making and the authorities are taking place at the local level, and so they're motivated by local goals, some of which are not developmental, could be predatory, could be for political motivations and so forth, and the restructuring process of the state-owned enterprises has not been necessarily a very transparent process.

And so one of the reasons why it is so difficult to pinpoint how many state-owned enterprises actually, in fact, exist in China today is because there are many companies that are registered as state-owned enterprises, but are, in fact, infused with private capital, and sometimes even foreign direct investment, and not necessarily capital from the banking system, in part, because of what you say, that misallocation of financial assets by localities.

COMMISSIONER BLUMENTHAL: I've run out of time, but if I can get from all three of you some kind of comparison of--I mean we know here in the United States just recently, and we're a pretty transparent country, we've had over the last decade investments in essentially quasi-state or state-owned enterprises, and we've seen massive amounts of waste, and so on and so forth, and inefficiency, and that's come out in the news.

I wonder if there's any way of getting the data on the amount of waste, inefficiency, capital misallocation in China that's, in fact, holding back the Chinese economy. Because of the dominance of state-owned enterprises versus what it would be like if you actually had a financial sector that was allocating capital efficiently to companies that were more productive?

And I guess we could follow up on that. I don't know if--do we have time for them to answer?

HEARING CO-CHAIR CLEVELAND: No.

COMMISSIONER BLUMENTHAL: Okay. If you can get--

HEARING CO-CHAIR WESSEL: If you could provide your response in writing, we'll submit it for the record.

HEARING CO-CHAIR CLEVELAND: We have two members of Congress showing up shortly, which is what my concern is about getting through everybody who wants to ask a round of questions, and then dealing with the members of Congress respectfully.

So can we take those questions for the record? Is that all right?

COMMISSIONER BLUMENTHAL: That's fine.

HEARING CO-CHAIR CLEVELAND: Okay.

Mr. Wortzel.

COMMISSIONER WORTZEL: Thank you all for your preparation and presentations here. I appreciate it. We all appreciate it.

Dr. Hersh, in chapter two of your dissertation, you tell us that many of these state-owned companies came up with the backing of the People's Liberation Army.

And, Dr. Hsueh, in your presentation, you discuss the fact that among some of these companies, telecommunications and information technologies is considered to be, you know, a special sort of national security arena by China.

And--is it Mr. Szamosszegi?

MR. SZAMOSSZEGI: Yes.

COMMISSIONER WORTZEL: Thank you.

Mr. Szamosszegi, you discuss the way that the Communist Party penetrates the companies and invests itself into the companies in kind of a controlling way. So, as I see it, you have not only state-owned enterprises, you have township and village-owned enterprises, and you have provincial-owned enterprises, and if you look at telecommunications and information technology, every province has its own provincially-owned telecommunications company, and many of them engage in manufacturing. So it's not just Huawei and ZTE.

Many large cities and municipalities have their own information technology manufacturers and companies. So if the Communist Party is fully invested in these organizations, should Americans be concerned when enterprises in this sector begin to establish themselves in the United States' telecommunications industry and infrastructure? Does this begin to constitute a threat to what we have established as open communications?

MR. SZAMOSSZEGI: I'll just respond briefly. I think this is--

HEARING CO-CHAIR CLEVELAND: Mr. Szamosszegi, excuse me one moment. We are going to take a quick break. I'm sorry. Congressman Visclosky is here, and we'd like him to speak for a moment. So Larry may have to repeat his question when we come back.

COMMISSIONER WORTZEL: I wrote it down.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Thank you.

Congressman, welcome.

HEARING CO-CHAIR WESSEL: Congressman, thank you for being here this morning. It's great to have you here.

Congressman Visclosky represents the First Congressional District of Indiana. He has been a real leader in the question of job creation, the question of what's happening to our nation's manufacturing base, a leader on "Buy America" and other job creating efforts.

The Congressman is a member of the Appropriations Committee and serves as Ranking Member on its Energy and Water Development Subcommittee, where he has worked to boost investments in new energy technologies that will help confront the energy crisis and reduce our dependence on foreign oil.

He also sits on the Defense Subcommittee, the Financial Services Subcommittee, and is Vice Chairman of the Congressional Steel Caucus.

Congressman, thank you for being here this morning. We look forward to your testimony.

STATEMENT OF PETE VISCLOSKY
A U.S. REPRESENTATIVE FROM THE STATE OF INDIANA

MR. VISCLOSKY: Commissioner, thank you. I want to thank all of the panel members. I apologize to my colleagues on the panel. I assume that given the serious nature of your inquiry and hearings today, you needed a bit of comic relief. I am here. I am here.

[Laughter.]

MR. VISCLOSKY: You do have my entire statement, I think, before you so I certainly will not read it in its entirety but would want to make a couple of points.

The first is that I can understand why the United States is so interested in investment by Chinese state-owned enterprises. For example, Nexteer Automotive in Saginaw, Michigan was on the verge of closing and losing 3,000 jobs, but a Chinese state-owned enterprise, Pacific Century Motors, made an investment. 3,000 workers, instead of looking for their next employment opportunity, are now installing new equipment because of the investment. So while this appears to be a positive development initially, I remain very cautious.

My concern is that there is no means for oversight or recourse for American workers if ulterior motives are involved and if the original investment dollars were generated through state subsidies that rendered other Americans unemployed.

The above-mentioned case is an apparent win for American workers, but what if the motive of the investment of the Chinese state-owned enterprise is to gain technology developed in the United States for export to China? What if the motive for the investment of a Chinese state-owned enterprise is to operate an American facility so they can avoid American tariffs?

Should we reward the use of investment dollars secured through practices that violate international trading standards and that have had an abusive effect on existing businesses and employees in our country?

I don't view my concerns as speculative. I do not assume that Chinese state-owned enterprises operate based solely on market forces and do believe that your purposes here today are very important because I do think its imperative we develop a way to transparently and fairly assess the investments that are being made.

Currently, the only mechanism known to me that America has to examine investments from Chinese state-owned enterprises is through the Committee on Foreign Investments in the United States. As a leader of the Congressional Steel Caucus and a member of Congress representing generations of steel workers in northwest Indiana, I have seen the devastation that Chinese currency manipulation and unfair trading practices have wrought on our manufacturing base, and again I have no reason to believe that Chinese actions through state-owned enterprises will be any fairer.

I do think that it is imperative that we assure that American workers are able to compete on a level playing field. China has consistently demonstrated that they are not adhering to fair trade rules. They have provided illegal subsidies to their industry. I do believe that they manipulate daily their currency. We pick up carbon from the domestic industry in China that produces steel in the state of California.

Some years ago, we had a national tragedy where I believe it was 13 to 16 miners died over the holiday period of time. In that same year, almost 6,000 people died in mining incidents in the country of China because I do not believe there is enforcement of worker protection.

Additionally, there are copious articles and reports of the theft of intellectual property, and, again, I do not believe that we need to reward these types of behavior that allow retained earnings to be secured to be invested in U.S. firms, others of which have lost employees because of these preceding actions.

So I come before you again today to express my deep appreciation for what you are about, and the fact that you're giving very serious thought to this matter, and asking for a wide range of opinions relative to it.

Also, would conclude by again thanking you very much, one, for the opportunity; secondly, for letting me interrupt the existing panel. I do appreciate the courtesy very much.

HEARING CO-CHAIR WESSEL: Thank you for coming, taking time this morning. You've been a great leader, as I said, on these issues.

Can I ask a quick question? Because, as I recall, you had also been involved in the Magnequench situation some years ago, and I saw in your testimony you mentioned the leadership you had regarding Anshan Steel and its potential investments.

As I recall in Magnequench, there was an assumption about what the deal was going to be, but afterwards the rules changed. Do you have confidence in CFIUS that what it decides on and the terms of a deal are actually going to be enforced long term that the government actually follows through?

MR. VISCLOSKY: I do not believe that that will be the case in the long term, and what I did not address as a member of the Defense Appropriations Subcommittee is my concerns relative to the national security aspects of the purchase of many of these corporations.

In the case of Magnequench, that was located in the community of Valparaiso, Indiana, they made a very precise type of magnet that is used in weapon systems in the United States. The theory was that when it was purchased by a Chinese firm, it was going to be retained in the United States of America. It was not. You lost the jobs, you lost the technology, and that technology applied to defense systems.

My concern here, and it's why I believe domestically we have a Federal Trade Commission and we have antitrust statutes to protect us from predatory economy activity, is the fact that for a period of time, this may be very placid and appear to be to everyone's benefit until a market is controlled, the technology is secured, and then someone turns the lights off.

So I am concerned from an economic standpoint. I'm very concerned about the theft of intellectual property, and particularly as it pertains to national defense, which in this case occurred in the First Congressional District.

HEARING CO-CHAIR WESSEL: Understand.

I know your time is short. Are there any other quick questions? Mr. Slane.

COMMISSIONER SLANE: Congressman, thank you for taking the time.

One of the things that I struggle with is Chinese steel companies, which are state-owned enterprises, want to come into the United States. Anshan Steel is a prime example. And they have little or no cost of capital.

How do American steel companies compete with a Chinese SOE that has little or no cost of capital?

MR. VISCLOSKY: I share your concern, and that was one of the issues that we posed with the Department of Treasury when the investment was made because there, again, is no comparability as far as what the costs are. And the fact is in the case of steel specifically--because you raise it--you now have four times more steel produced in China than in the United States.

I'm not suggesting that everything was below board, but clearly there was a governmental policy that "x" number of tons were going to be produced, and, again, as far as labor standards, the paragon of American industry, Apple, is now in the news relative to working conditions in China.

I add to that, again, my earlier remarks, that the carbon from those mills in China is now present in the United States of America along our west coast. Those were not plants built in the 1930s. So it's the subsidy of that investment capital that you rightfully point out and all of these other attendant issues that are an example using steel that can also be transferred, I believe, to other industries.

If it is reasonably fair, and I understand it is an international environment, it is an international economy, but I think our role in the United States is to make sure that people begin to adhere to a basic set of standards as far as the financing of industry, of the protection of our global environment, and basic working conditions and human standards, and then when you have hit at least a reasonable plateau, then let's do some trade deals.

But it is impossible to compete, and you couple that with, again, my assertion that you do have manipulation of currency. You cannot expect anyone if they're working 24 hours a day to compete effectively with that type of policy, and I think it is demonstrated in the fact of the collapse of manufacturing in the United States.

And if I could--you didn't ask the question, but it just bugs me so I just feel compelled to mention it--Mr. Summers, who has now left the current administration, about a month before he left said he was not concerned--and I'm paraphrasing his remarks--about the loss of manufacturing in the United States because we are moving to a knowledge-based economy, which I find personally offensive, and I tell people the day you stop making this pen in the United States and decide how you hold the ink in it and how you fashion the metal and —decide you don't need a machine to do that, and if you don't need the machine, you don't need to engineer the machine, and you don't need to make the machine more efficient next year because you're not in competition, and moving money around is not the basis for a new economy for the young people of this nation.

So I really do appreciate your taking a thoughtful approach and hearing from all aspects of the issue to try to see how we can, at least with some transparency, as a government and as a people attach a value to these types of investments.

HEARING CO-CHAIR WESSEL: Thank you, Congressman, for your time.

MR. VISCLOSKY: Thank you very much.

HEARING CO-CHAIR WESSEL: Look forward to working with you and your staff over the coming months.

MR. VISCLOSKY: Great.

HEARING CO-CHAIR WESSEL: Thank you.

Panel I – Questions and Answers

HEARING CO-CHAIR CLEVELAND: Commissioner Wortzel, would you like to offer an abbreviated version of that?

COMMISSIONER WORTZEL: I'll abbreviate, but just to cover it again, Dr. Hsueh, you told us that telecommunications, information technologies, that is considered of national security importance in China. Dr. Hersh, you tell us that many of these companies evolved with PLA backing and influence. And Mr. Szamosszegi, you tell us that the Communist Party is very heavily invested in these companies and actually picks sort of who runs them.

So given these facts, should Americans be concerned when enterprises in this telecommunications and information technology sector begin to establish themselves in the U.S. telecommunications industry and infrastructure? Does that leave us open to influences, manipulation, penetration by the Chinese state if it exercises the control it can over these industries?

MR. SZAMOSSZEGI: It is wise to be concerned. I am not at all a technologist. But from talking to people with a better understanding of such circumstances, security can be compromised in situations when the equipment and/or and software are provided by a state-owned enterprise and must be operated by employees of that enterprise. This potentially has dramatic implications for national security.

So I think, yes, it's natural that we should be concerned about this because a state-owned company whose executives are picked by the Organizations Department of the Communist Party and whose shares are owned by the Chinese government may behave differently than a firm that is purely private. So we should be concerned.

DR. HERSH: To your question, I would say that, yes, we should be concerned, but this should not be a blanket fear that we apply across all potential investments coming from the Chinese economy into the United States.

As a country and as policymakers, we should pursue deciding where within our economy are the areas that have key technologies of national security and economic security importance; we should identify those and make clear where investments should be attracted and where investment would not be welcome.

But I would add that even though government involvement in the economy is happening at many levels and differently, within government ownership and privately-owned companies, there is not one unified Communist Party coordinating and organizing economic activities. There are many factions within the Party. These factions divide along ideological lines. They divide along the lines of economic interests. They divide along the lines of regional interests.

Where the action is happening in industrial policy at the level of developing individual firms, mostly at the local government level, local government officials are operating with a great deal of autonomy. They're making decisions in their own interests, and these decisions are being made often without the knowledge or the support of the central government in Beijing, and they're all in competition with one another.

The decisions may not be motivated by a nationally coordinated strategy of the central government in Beijing to--

COMMISSIONER WORTZEL: Should it matter to us whether we're penetrated by the central government or by the provincial government of Shanxi Province which controls two telecommunications companies that work on electronic warfare equipment?

DR. HERSH: I think it should matter to us whether technologies of national security importance or of economic security importance are at exposure to expropriation. But at the level of the individual firms which are operating as independent businesses, even when there's local government involvement, this is a strategy that even private firms pursue.

If it's more cost effective to go out and buy a company that has an existing technology rather than develop it yourself, that's a smart business strategy.

DR. HSUEH: To quickly answer your question, I do think that we should be concerned, but in an educated and guarded way, and so it really depends on the industry and the subsector and market segment that we're talking about.

In response to your example of telecommunications equipment, it's within the industry one of the subsectors that was actually decentralized very early on, and the restructuring process began very early on. So Huawei does have PLA, some of the original stakeholders. Today, it's tenuous whether the PLA is actually involved in daily operations.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

We're going to go to Congresswoman Myrick for her testimony now. Congresswoman Myrick came to Congress in 1995 after building a successful advertising and public relations business and serving two terms as mayor of Charlotte, North Carolina, the state's largest city and commercial hub.

She serves as Vice Chairman of the powerful Energy and Commerce Committee and is a member of the Health Subcommittee. In 2009, she was selected by the House leadership to serve on the House Permanent Select Committee on Intelligence, and in the 112th Congress she was named Chairman of the Subcommittee on Terrorism, Human Intelligence, Analysis and Counterintelligence.

I should also point out that we understand that you recently announced that you would be retiring from public office, after you have devoted so many years to public service and done a great job for your constituents and have been a real asset to Congress.

Please, Congresswoman, we look forward to your testimony.

STATEMENT OF SUE MYRICK
A U.S. REPRESENTATIVE FROM THE STATE OF NORTH CAROLINA

MS. MYRICK: Thank you very much, Commissioner Cleveland, Commissioner Wessel, and the rest of you.

Thank you for your time in doing this, first of all, and thanks for having me today because this is an issue that I have been concerned about for a long time, and really a lot of other people would not pay attention. And so I'm glad that you're devoting some time to this today so hopefully, we can get more exposure on it and people will become aware of what's really happening.

The concern I have had all along is the fact that so many of the companies in China who are, in effect, state-owned or state-supported are now coming into America, which they didn't do before, and trying to get a foothold in our economy in a way that we hadn't seen, and what really concerns me about it is when you look at the connections between the state and, particularly, I have been working on Huawei and the telecommunications industry and how that is affecting us as a country, and everything that they do over there is different than what we do.

I mean none of the rules apply, and the regulatory situation is totally different, et cetera, et cetera, and so we've been watching this for some time, and when you talk about the Chinese government, I know that the PRC says that they want their economy to be stable and all of that, and I believe that, but by the same token, the way they run their affairs and how they do it and the control they have on the businesses, not only our businesses that do business in China, which is a whole other story, but the ones that are coming here, really is very concerning to me because they aren't trustworthy in the sense of what we usually think of.

They don't value basic human rights, human life, any kind of religious or other freedoms the same as we do, and most of the time they're on the opposite side of our country's foreign policy. I mean that's totally what you see they do in the U.N., et cetera.

So they, also, of course, have a history of developing cyber warfare, which is a whole other issue that we are taking extremely seriously in our Intelligence Committee because this is something that we're only in the beginning stages on, in my opinion.

So when we consider the Chinese-based companies that are in the sensitive telecommunications or any kind of telecom, it really concerns me that they would be able in any way to get a foothold into our systems because once they get in the system, then where are they going to go from there?

We don't have any control over that, whether it's switching equipment, whatever they may be providing. So I know they're one of the largest manufacturers in the world. I'm sure you're all aware of that, too. And they are using what I consider to be unfair business techniques to be able to get a foothold in this market when they have to compete with our companies.

And so it puts American companies at a really strong disadvantage, and, of course, the Chinese companies deny any kind of implications that they're tied to the Chinese government, to the PRC. They send letters to me because I write letters all the time, and they send these letters saying, oh, you know, we don't have anything to do with them. But, yet, when you go back and look at all the relationships that exist between the people who are running the company and the PRC, it becomes pretty apparent that there is some connection there.

And so I'm just concerned about how they could compromise us, not just in our telecommunications but any of our government infrastructure, even military law enforcement, private citizens, private companies, in any way. So they've done business with other regimes that haven't exactly been above board either--Saddam Hussein back when he was still ruling, the Taliban, modern day Iran--and they have been sued a lot of times for this participation with other companies with illegal activities, but it doesn't seem to stop what they do.

They have a strong lobbying effort, as you're probably aware, here on the Hill of people coming in to tell everybody how great they are, and all of these so-called rumors aren't true about the ties with the company, and so forth.

So I understand capitalism, free enterprise are new concepts in China compared to their history, and that they very much want to move in that direction, but I have concerns as to how much of a capitalist, free market society really can exist because of wanting to keep control--the Communist government to keep control over everything, which seems very apparent.

And, yes, I know there's a new set of leaders coming in the military and other things that maybe will change some things over time, but right now it's not. So they're very heavily state dominated in everything they do, and that's my real concern.

So I think when we look at our market, we look at them, and the fact that we would really allow them into our sensitive telecommunications industry I think is a terrifically horrible mistake. I can't emphasize that enough.

And so I know you've worked very closely on this issue, and I want to thank you for the reports that you have put out, what you have done, because it has helped what we do very much, and, again, the time that you've put into it is very important, and I know my Senate colleagues, John Kyl, and I have worked on this for a couple of years, and he and others are very concerned about it.

As I mentioned, our House Intelligence Committee is extremely concerned about this particular issue, and we welcome any suggestions, and I welcome any suggestions, you all might have that would be helpful to us as we move forward on our side in doing what we do and, hopefully, along in conjunction with you and what you do, and, again, I just thank you for the opportunity to be here and for the work that you're doing. I'm just so happy somebody is paying attention.

Thank you.

HEARING CO-CHAIR WESSEL: Thank you, Congresswoman, and believe that we pay attention to what you and your colleagues are doing in the cyber security issues, which we have spent a lot of time on, and I think one or two of us, only speaking for ourselves and not for the Commission, there are a lot of concerns we have.

You mentioned the question of Huawei and its market penetration. I think there are a lot of people who have looked at their trade relations with the country and believe that they are either dumping or subsidizing their products to try and gain a foothold in our market.

The Commerce Department has self-initiation authority under

AD/CVD. They could be acting. Huawei is trying to integrate itself. This morning I pulled a little clip out of The Washington Post that the GSA has now approved--beyond their BlackBerry, which, as you know, has the CryptoBerry and a number of other things for U.S. government employees--they're now going to allow other platforms. Huawei makes handsets.

And so--

MS. MYRICK: I have not seen that. Thank you for telling me.

HEARING CO-CHAIR WESSEL: Well, and we met--Larry and I met a week or so ago with some procurement officials and found out that there are some questions about whether military systems are fully protected. If it's on a munitions list item that it can be protected. If not, and C4ISR, as Larry, as I recall, is not on the munitions list.

So the procurement of foreign equipment for C4ISR purposes is now open.

MS. MYRICK: Scary.

HEARING CO-CHAIR WESSEL: And that goes to the core of your jurisdiction.

MS. MYRICK: Thank you. Exactly.

HEARING CO-CHAIR WESSEL: Larry, did you have a comment?

COMMISSIONER WORTZEL: I do. First of all, Congresswoman, thank you very much for your work and your attention to this.

I would not look only at Huawei.

MS. MYRICK: Oh, I understand.

COMMISSIONER WORTZEL: Most of these Chinese telecommunications companies have essentially the same genesis or genealogy, out of either the Communications Electronics Department of the People's Liberation Army or the Electronic Warfare Department of the People's Liberation Army, and they were started by people from there. They were influenced and supported by them, and many of their executives come out.

I mean we were in a fairly remote part of China three years ago at what looked like a--it was supposed to be a plant that made control equipment for cleaning power production facilities, the air at power production facilities.

I opened the big server boxes, and the servers in there were made by a provincially-owned company, and we went by that factory, and there was an entire electronic warfare regiment of the People's Liberation Army being outfitted. So these companies are on both sides of the street.

I think that my recommendation is that the approach we take to this problem is the approach we take on human intelligence threats in our counterintelligence community, that just as we have a classified criteria country list where the Justice Department, the FBI, and the community say be careful of representatives of these governments or countries, don't let them into your national security architecture, report your contacts with them, I would suggest developing a criteria cyber threat list.

MS. MYRICK: Yes.

COMMISSIONER WORTZEL: It might be the FBI or Justice. It might be the National Security Agency or other parts of the intelligence community that have to cooperate, but if we had a list that names the countries and the companies or entities and even people that have the most active and egregious records of cyber threats and attacks and cyber espionage against the United States, we could then know who we ought to exclude from sectors of our economy.

MS. MYRICK: And you're saying make that public?

COMMISSIONER WORTZEL: No, I don't think you need to make it public. I think it would be a mistake to make it public. I think it should be a classified list, just like the criteria country list.

MS. MYRICK: Right.

COMMISSIONER WORTZEL: But we could then require every defense industry or critical infrastructure and our federal government to stay away from companies and equipment produced by the countries that are on that list.

MS. MYRICK: No, I appreciate it. Being on Intel, I have to be careful what I say.

[Laughter.]

HEARING CO-CHAIR WESSEL: For a quick comment, Commissioner Fiedler.

COMMISSIONER FIEDLER: Speaking of which, I think that their presence in Canada has been an unexplored security concern, and I would just sort of not make any allegations, but leave it at that and say that it should be pursued.

MS. MYRICK: Yes, I appreciate that very much and am aware of that. Thank you for bringing it up.

HEARING CO-CHAIR WESSEL: Thank you, Congresswoman. We look forward to working with you and your staff, either on your personal basis or your committee basis, and please don't hesitate to call on us. Thank you for being here this morning.

MS. MYRICK: Again, I appreciate what you all are doing. So keep it up.

HEARING CO-CHAIR WESSEL: Thank you.

Panel I – Questions and Answers

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

CHAIRMAN SHEA: Thank you all for being here and for the time and effort you put into your presentations.

I just want to address my first question--I have two questions--and address my first question to Mr. Szamosszegi. In the paper you co-wrote for the Commission last year--I'm just reading off the executive summary--you say when it joined the WTO in 2001, China promised that the government would not influence directly or indirectly the commercial decisions of SOEs. China does not appear to be keeping this commitment. The state does influence the commercial decisions of SOEs, and the most recent five-year guidance does not herald a change in this regard.

That's a big broad statement. Just could you give us a few examples, a couple of examples of where the state, Chinese government or the Communist Party has influenced the activity of an SOE in a noncommercial way?

MR. SZAMOSSZEGI: Sure.

CHAIRMAN SHEA: Anywhere in the globe. With respect to foreign direct investment.

MR. SZAMOSSZEGI: With respect to foreign direct investment, I would say that investments in African countries that private sector subsidiaries of these Chinese SOEs would not engage in are routinely undertaken by the state-owned enterprises in line with government policy.

CHAIRMAN SHEA: Okay. Moving forward, the point was made that there's very limited Chinese FDI in the United States. Could you speculate, just going forward, how the state may influence SOEs to act in a noncommercial way with respect to FDI investments in the United States?

MR. SZAMOSSZEGI: Well, it would be purely speculation, but my own personal view, and from looking at data, is that foreign direct investment from China into the United States is likely to increase in the coming years. Until recently, this investment has occurred at very low rates because Chinese enterprises have been following what their government has actually promoted, which is resource intensive foreign direct investment in Africa and in Australia, So I think now the nature of the Five Year Plan has changed because the focus is on new emerging industries, and these emerging industries are not located in Africa, and they're not associated with natural resources.

So if I have to speculate, going forward, I think that there will be investment from state-owned enterprises and other enterprises from China into the United States in areas that are specified in the 12th Five Year Plan.

CHAIRMAN SHEA: Okay. Let me ask you, follow-up on a question that Commissioner Fiedler raised, about what do we call the Chinese economic system? And there is a book put out a couple of years ago by a couple of Western investment bankers who spent a lot of time in China called Red Capitalism. I don't know if you're familiar.

And they say this: What moves this structure--meaning the Chinese structure--is not a market economy and its laws of supply and demand, but a carefully bound social mechanism built around the particular interests of the revolutionary families who constitute the political elite. China is a family-run business. When ruling groups change, there will be an inevitable change in the balance of interests, but these families have one shared interest above all others, the stability of the system so they can pursue their own special interests.

Do you--I would love each of you to comment on that statement. Dr. Hsueh.

DR. HSUEH: Thirty years of market reform obviously have made many changes to the system, and, as I say, I think overall on the macro level, we can make the statement that the Chinese central government has enhanced its bureaucratic coordination capabilities and overall regulatory capacity has increased, but not in all areas of the economy because there are certain areas that are just not as important anymore.

In those areas where the government has let go of bureaucratic coordination and capacity, there is the emergence of many different stakeholders.

CHAIRMAN SHEA: So you think that statement is an overstatement?

DR. HSUEH: I think it is an overstatement. I do think that if I were to be pushed to make an overall adjustment, I do think the central government is stronger and has more capacity today. But there are many areas, issue areas, that are just not of concern, and the overarching goal is national security, the development of a national technology base, and, importantly, social and political stability.

And if those goals are achieved, there are going to be many different issue areas, sectors, market segments, and so forth that the central government is just not going to spend--it's not worth their time. It's not worth the time to cover. And so, as a result, there are many different stakeholders that are out there in the economy that will be motivated by personal goals that may not have effects for the Chinese Communist Party overall.

CHAIRMAN SHEA: Do you want to make a quick comment, Dr. Hersh?

DR. HERSH: Sure.

CHAIRMAN SHEA: We're over, but--

DR. HERSH: As we see, we can deduce from the behavior of leadership in the central government as well as from statements of key leaders that the primary goal is the preservation of continued Communist Party rule of the Chinese government, and one of the main factors that will ensure they achieve this goal is to have continued strong economic development and social stability that steadily increasing living standards brings.

And so the focus of much policy is on how to continue developing the productive economy in China and improving living standards. This is not a goal driven by a family orientation, as you say, within the--

CHAIRMAN SHEA: As the investment bankers said. Not I. I'm just saying that the person who made the statement that that China is a family-run business, is not--I didn't make that statement. Someone else made the statement.

DR. HERSH: Sure. This is a priority that is inculcated throughout the structure of the Party system and the government, not limited to those revolutionary families, as the author puts it.

CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Madam Chairman.

I just can't help but following up Commissioner Fiedler's description of that and also a comment spawned on the family-run business. I think we'd be kind of better off in being able to describe this structure if we had this hearing in Sicily.

[Laughter.]

COMMISSIONER D'AMATO: In any case, I would like a follow-up on Commissioner Blumenthal's question on capital allocation. We had a hearing recently on resource allocation, resource management by the Chinese--water, fuels and other things.

My question is on the range in size of the SOE place in the economy, up to 50 percent of GNP, the range of industries labeled as champions, you know, huge description--alternative energy companies, high-end manufacturing. These are large, large descriptions of the kinds of companies that are included. Are there any ongoing assessments of the impact and costs of the concentration of economic power here on the allocation and efficient use of resources like fuels, water, land, minerals?

We know, for example, in the water situation that it's tremendously inefficient. It's not priced properly. We know they're going to run out of domestic oil within ten years and coal within this century. So they're using up their resources inefficiently, at an astonishing rate.

Is there any kind of ongoing assessment as to the impact of this concentration of power on the allocation of scarce resources in China, and if there is not, should there be? Why don't we just start with you?

MR. SZAMOSSZEGI: I do not know of any broad-based assessment of the kind that you've described, but I think that the whole state capitalist or state-guided capitalist model in China has created growth that is in many ways input driven. This actually gets to Commissioner Blumenthal's question. We can tell by looking at a state-owned enterprise's profitability compared to the private sector in China that they are not as efficient.

And yet there can be a strong case that in the past several years, they have actually been, instead of declining, a case can be made that SOEs have been growing. Because the state-owned enterprise's growth is input-based and since resources in China are mispriced in order to facilitate growth of these un-economic enterprises, there is naturally depletion that would otherwise not occur if things were priced properly.

And so I think this is a case where China, in a sense, is shooting itself in the foot by using this model, but at the same time, many of their investments create excess capacity, and that excess capacity results in exports that harm our economy, and I think that's another important aspect of the equation. China is not only misallocating resources with this state-owned model, but is also harming U.S. interests in many cases.

COMMISSIONER D'AMATO: Thank you.

Dr. Hersh, do you have any thoughts on that?

DR. HERSH: Yes. It's clear that the institutions in China's economy do lead to a misallocation of resources, and particularly at the level of individual companies, individual state-owned enterprises, we can see that many operate in a very inefficient way.

And if you look past the individual companies to how this structure works as a whole within China's economy, it actually functions to create many efficiencies that may not be there without this active management of the state-owned enterprises and more broadly the government-owned sectors of the economy.

What I mean by this is that the maintenance of state-owned enterprises plays a significant role in the overall macroeconomic demand management within the Chinese economy. It helps keep the overall level of employment high. That means that there's wages out there for consumers to be spending on goods.

It helps keep demand high for many privately-owned companies that are upstream in the production chain from the state-owned enterprises, and that has benefits to private enterprises within the Chinese economy as well.

It allows those companies to achieve higher capacity utilization, more efficient economies of scale and production, and through that, to achieve productivity growth through learning by doing, able to achieve efficiencies in their production, which will let them become efficient enough and have high enough quality products to enter export markets.

So, then, at the individual level, we may see that some SOEs are inefficient, but at a system-wide level, this structure is helping the overall economy achieve higher level of efficiency.

Now, doing it through state-owned enterprises is one way to do that, and that's how China does it. In other countries, we have macroeconomic policy tools, fiscal policy and monetary policy, to try to manage a high level of aggregate demand to ensure full employment and that companies operate at full capacity.

And let me just say something about the allocation of capital from the banking sector, which you alluded to and which Commissioner Blumenthal also asked about.

The banking sector provides roughly 20 percent of the overall investment capital in the Chinese economy in a given year. So relative to other forms of investment, it's actually quite small. Not all of the loans that are being made by the domestic bank system are going to state-owned enterprises. Not all of them are operating--being extended on a noncommercial basis although, of course, we know that this happens.

Having access to low-cost capital is, of course, a great benefit to the companies in China that receive this, but I would also say that in the United States, companies have access to very low cost of capital. Right now in the United States, nonfinancial corporations are holding roughly $2 trillion in cash assets that they're not using for investment. That's free money for them.

They can raise money on private capital markets at virtually no cost, less than one percent rate, extremely low cost of capital for them. They're not using this money to make productive investments in the real economy here in the United States even though they also have low costs of capital. Rather what they're doing is taking this money, using it to prop up their own share prices. Companies are spending 108 percent of their profits in order to buy back their own shares and to pay out dividends to shareholders in order to keep their share prices up.

The issue is more than just getting low cost of capital from the financial system. We have to look broader at the institutions which are influencing, creating incentives for where and how investment takes place so that we can channel investment into productive uses.

DR. HSUEH: I would just add that a lot of the allocation problems and some of the social, political and economic implications are happening in the decentralized industries, and so regulatory enforcement has been decentralized to local levels, and oftentimes these are the industries where you see overexpansion, market saturation, and approvals of market entry and allocations of capital are given to either state-owned enterprises, state-controlled enterprises, or just enterprises owned by individuals with connections, with strong connections to the state or Chinese Communist Party.

So it's not just the state sector, per se, in these decentralized industries, and it is because of the institutional landscape that has emerged in the last 30 years and the incentive structures that have been built into the institutional landscape.

COMMISSIONER D'AMATO: Thank you very much.

HEARING CO-CHAIR CLEVELAND: Thank you.

Commissioner Slane.

COMMISSIONER SLANE: Thank you for all coming, and we appreciate your time and your testimony.

I'm trying to understand these state-owned enterprises, and as a businessman, I find it very curious that politicians are appointed as the senior management of these state-owned enterprises, and while I don't want to put too fine a point on it, it doesn't seem to me they have the skill set, the experience, the training, the education to run large public corporations, and then they rotate them out every couple of years, and they seem to be looking at their next political move, not where to direct the company.

But notwithstanding that, I still see that these companies seem to be improving, to me, in certain industries. Telecommunications. Huawei is a formidable competitor. Automotive, aviation, and others. And I'm trying to understand what I'm missing here, and how these companies--are they improving? Is it something that we should be worried about as Beijing pushes them to go abroad?

And it seems to me that their currency of the realm is employment; ours is profit. And so now as they enter the global market, that dynamic has to change.

Thank you. Any thoughts?

MR. SZAMOSSZEGI: I think that employment is important, profits are important, but I think that China currently is still undergoing a dramatic reform in which it has gone from having a bloated state sector to a more efficient state sector. And so I think employment is important, but if you look at the past history, the past 20 years, there's actually been a significant decline in employment within the state sector, the state-owned enterprise sector.

At the same time, the private sector has been creating jobs, and the state-owned sector has been branching out into these mixed forms of ownership, and they've been able to maintain high levels of employment for the economy as a whole.

I think that the management of state-owned enterprises is becoming more sophisticated over time. I think that it is true that you have government officials and Communist Party members who are put into the companies, but I think increasingly they have better training and are able to act as better managers.

And I also think that the other things that you mentioned, like the improvements in performance, are due to a number of factors aside from improved management, The introduction of technology from abroad, and subsidies alike low interest rate loans makes SOEs more competitive and able to generate profits that otherwise wouldn't be there. And with those profits, they can invest in buying more advanced equipment.

Then they can hire. Once you get that equipment, you hire people from the companies who make it to come and teach you how to operate the equipment, and all of a sudden you raise the entire skill set of the manufacturing sector, even in state-owned enterprises. Even if they're not very efficient, they can still improve relative to the past when they were highly inefficient.

DR. HERSH: So political officials in China typically have very different career trajectories from those here in the United States, and one of the aspects of economic reforms beyond institutional changes--this was a campaign carried out by Deng Xiaoping--was to transform qualitatively the state of the bureaucracy within China, purging out those who were put there as rewards for their service in the revolution and bringing in a new generation of leaders who were trained and had experience in engineering, sciences, management, economics. So there is a qualitative improvement in the skills of government officials that's been happening throughout China's economic reforms.

The career trajectories of government officials typically run something like they work in a government-involved enterprise in a management capacity for some time. They learn how that business operates. They are successful in managing that business, and that leads to promotion and through to the other side of the system to the governance side in a position where they have responsibilities for overseeing, coordinating economic development projects overall.

So those officials are bringing in increasingly more skills in operation of business and in technological knowledge and to governance.

DR. HSUEH: To understand the management of state-owned enterprises, it's very important to look at the restructuring process of the particular industry in question.

Many industries and state-owned enterprises today used to be part of a government bureaucracy staffed by technocrats, and so as some of these bureaucracies have been dismantled over the reform era, many of the technocrats have been appointed in managerial roles within state-owned enterprises. So many of these managers were at one time or other bureaucrats within a government body that no longer exists today.

But you also see the other direction of where entrepreneurs that have won favor within the Chinese Communist Party then being assigned an important role within an important national campaign.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR CLEVELAND: I have sort of a yes or no question for you. The economists in Unirule Institute in Beijing report that real return on equity between 2001 and 2009 was probably close to negative two percent, if you take out subsidies and not paying market rate loans, and I think, Mr. Szamosszegi, you said the same thing.

Given that real return, is this model sustainable? Yes or no, I guess is what I'm really--because we need to wrap up.

DR. HERSH: I'm not familiar with that analysis although I would be very interested to look at it, but the profitability measured in that way I don't think would be the indicator of a constraint on the sustainability of China's economic model.

I think the constraints that will bind on China's economic model, as we look to the future, are the tremendous pace of the environmental degradation caused by development and the social stresses caused by the very unequal treatment of workers within the economy.

HEARING CO-CHAIR CLEVELAND: Dr. Hsueh.

DR. HSUEH: I would say, yes, in the short term, for sure, and I think the jury is out for the long term. If you look at the most important motivating goals for the Chinese government, political stability is a very important one. And for now, the model is providing social and political stability despite economic degradation and, you know, rising inequality, and so, yes, for now, it is sustainable.

HEARING CO-CHAIR CLEVELAND: For now? Five years, ten years? What's your--

[Laughter.]

DR. HSUEH: I would say for the next 15 to 20 years, it is sustainable.

HEARING CO-CHAIR CLEVELAND: Mr. Szamosszegi, you get the last word.

MR. SZAMOSSZEGI: Yes, it's sustainable. For how long, it's hard to say. The power of compounding really kicks in after awhile. So I'll put my vote on 30 years.

HEARING CO-CHAIR CLEVELAND: Wow. Interesting. Well, we really appreciate you all appearing. I've learned a great deal, and we will take a break for 15 minutes and be back at 11:15 to hear the next panel.

So thank you very much for coming.

DR. HSUEH: Thank you.

[Whereupon, a short recess was taken.]

Panel II – Competitive Challenges Posed by SOEs

HEARING CO-CHAIR WESSEL: Let's get started since our witnesses are all here. Our Commissioners will be dribbling back in, I believe, over the next minute or so. I want to thank you for being here.

Our second panel today will consider the competitive challenges that Chinese state-owned enterprises pose or may soon pose to U.S. enterprises competing with them in China, in the U.S., and in third-country markets.

With us today is Mr. Timothy Brightbill, Partner at Wiley Rein. Mr. Brightbill represents clients on all aspects of international trade law and policy, including import trade remedies, global trade policy and trade negotiations, international arbitration, export controls, climate change policy, customs matters and international e-commerce issues. I can't think of anything you don't work on. So it's great to have you here today, Tim.

Mr. Brightbill is the lead attorney for the Coalition for American Solar Manufacturing in its antidumping and countervailing duty cases filed against Chinese solar cells. The case is among the largest ever filed against China.

Next, we have Dr. David Gordon, Head of Research and Director of Global Macro Analysis at the Eurasia Group. Before joining Eurasia Group, Dr. Gordon spent more than ten years working at the highest levels of U.S. foreign and national security policy processes.

Dr. Gordon served as the Director of Policy Planning under Secretary of State Condoleezza Rice, where he played a leading role in developing policy ideas for Rice on issues ranging from Afghanistan and Pakistan to U.S. engagement in East Asia to the international financial crisis.

He also led the department's strategic policy dialogues with more than 20 countries around the globe.

Prior to his work with the U.S. State Department, Dr. Gordon served in a top management role at the National Intelligence Council, was director of CIA's Office of Transnational Issues, and worked as a national intelligence officer for economics and global issues at the NIC.

Finally, we have Dr. Paul Saulski, Adjunct Professor of Law at Georgetown University Law Center. As an adjunct professor at the Georgetown Law Center, Professor Saulski teaches courses on international securities regulation and on China's financial markets.

His current research focuses on the development and reform of China's capital markets and its impact on the governance of Chinese companies.

Though he does not appear in this capacity today, which I'm sure he will emphasize in a moment, Dr. Saulski is also Senior Counsel in the Office of International Affairs at the U.S. Securities and Exchange Commission where his duties include advising and assisting the Commission and its staff in the areas of international regulatory policy, comparative financial regulation, and cross-border enforcement and investigations, particularly in relation to the East Asia region.

Professor Saulski has recently returned to the SEC from a year-and-a-half detail to the U.S. Senate Banking Committee, where he served as a senior policy advisor on issues of U.S. and international financial markets reform to the Banking Committee's Subcommittee on Securities, Insurance and Investment.

The resumes of each of the participants are much longer and broader than I read, and we appreciate not only all of their experience but their being here today. Your statements will be made part of the record. If you could limit your oral testimony to seven minutes, and in your responses to questions, try and make them as abbreviated as appropriate so that we can get to as many questions as possible and potentially to a second round of questioning.

Mr. Brightbill, why don't you start?

STATEMENT OF TIMOTHY C. BRIGHTBILL
PARTNER, WILEY REIN, WASHINGTON, DC

MR. BRIGHTBILL: Good morning. Thank you for this opportunity to testify before the Commission on an issue of growing concern in the United States and in markets around the world.

The rise of state involvement in the global economic arena is a significant threat to our free market system and the free flow of private capital. China's use of state-owned and state-controlled enterprises, in particular, is a disturbing trend with potentially significant economic and security implications for U.S. companies.

More than any other country, China has created massive state-owned and controlled national champions that are designed to be competitive on the international stage. These SOEs are instrumentalities of the state, subject to varying degrees of direction and control by the Chinese government. They are often motivated not only by business objectives, but by government objectives, including securing of advanced technology, access to raw materials, job creation and geopolitical influence.

Before discussing some of the competitive challenges posed by SOEs, I'd like to make some initial observations. First, these SOEs can take many different forms, and their operations are extremely nontransparent, which makes it very difficult to assess their trade-distorting effects.

Second, the influence of many of these state-supported enterprises is not declining in China; it is expanding. For example, the Chinese government is the biggest shareholder in China's 150 largest companies.

The degree of state involvement in economic activity is growing in certain sectors, and the Chinese government is increasingly pursuing ownership, control, and direction of key industries, such as steel and raw materials.

In China, 95 percent of the production of the top 20 steel groups in China is subject to government ownership.

Third, the goals of these SOEs are well known and set forth by the government. Pursuant to China's "Going Abroad" strategy, manufacturing, mining and renewable energy SOEs now receive very large amounts of government support to invest overseas.

Fourth, as a result of this government support, China's outbound investment is growing rapidly. In the last few years, it grew by more than 600 percent, and the vast majority of that was by state-owned enterprises.

China's state-owned and controlled enterprises are arguably the single-greatest threat to U.S. trade competitiveness--in China, in third countries, and even here in the United States. So I'd like to turn to some of the various ways in which these state-owned enterprises can distort trade and potentially harm U.S. companies and industries.

First, these enterprises often engage in unfair trade practices such as dumping and subsidies. Many Chinese state-owned enterprises receive massive subsidies and other benefits from the government providing an unfair competitive advantage in their worldwide operations.

These can include direct subsidies, such as cash grants or capital infusions; preferential loans and access to capital; preferential access to raw materials and other inputs; and also tax reductions and exemptions. These subsidies and other benefits artificially lower state-owned enterprises' costs and enhance their ability to sell at lower prices than their private sector competitors.

Second, many of these state-owned enterprises are not motivated by profits or shareholders, and they may have little incentive to make production, pricing or other business decisions based solely on market principles. Many enjoy outright exemptions from bankruptcy rules. Some are not required to pay dividends or any return to shareholders. They may be more inclined to engage in anti-competitive pricing strategies, and SOEs will have less incentive to operate efficiently if they're not subject to the threat of takeover or the discipline of capital markets.

Third, SOEs in China may be exempt from a host of regulations that govern other businesses and industries.

Fourth, the lack of transparency that characterizes China and its SOEs can distort the market.

Fifth, Chinese SOEs are regularly favored in the purchase or sale of goods and services, particularly in China, which is the world's fastest growing market.

Sixth, China's banking system, labor unions, and pension investment funds are also state-owned or controlled, which in turn distorts many other market segments and industries within China, even those that do have private ownership.

These and other anti-competitive effects, which have been extensively documented by the OECD and others, often force U.S. companies to compete in global markets with the Chinese government rather than with private companies.

China's renewable energy sector demonstrates the nature and extent of Chinese subsidies and resulting market distortions. China's solar industry has become the world's largest over the past decade, primarily as a result of massive government support.

In the last two years alone, state-owned China banks, Chinese banks, have provided more than $40 billion in preferential loans or credit to Chinese solar producers--an unprecedented amount, even for China.

These subsidies have been granted pursuant to government industrial policy. Since 2005, China has proclaimed a national policy to support and expand its solar and renewable energy industries. The Chinese government has heavily invested in and owns large segments of green energy technology and manufacturing.

For example, polysilicon is the single largest input into solar cells and modules. For years, China obtained most of its polysilicon from the United States and other market sources. However, with massive government support, China has now built its own polysilicon industry, and today nearly all of the largest Chinese producers of polysilicon are state-owned and controlled, which unfairly benefits China's solar manufacturing industry.

Notably, these distortions in the solar industry are not designed to serve the Chinese market but to reach out to the world solar market. China exports 95 percent of its solar production and has built capacity far beyond demand, either domestically or even around the world. This has injured the U.S.

solar industry and distorted the global market for solar products.

Since 2010, at least 12 U.S. companies have been forced to close, declare bankruptcy or engage in substantial layoffs due to China's government support for its solar industry and the mandate to go abroad.

To conclude, by making its state-owned enterprises artificially competitive in world markets, the Chinese government has at times disadvantaged American companies and industries wherever they compete. As Chinese state-owned enterprises continue to expand, they may further distort global markets and cause more harm to U.S. companies and their workers.

If these entities expand their presence to the United States, we must ensure that any SOE investments or operations here take place on a commercial basis. In short, the United States must make it a priority to address the potential market distorting effects of Chinese state-owned enterprises in the U.S. and global markets.

I look forward to sharing with the Commission some ideas on how the United States can do that, as well as some other details on the effect of state-owned enterprises in the solar industry, in the steel and basic manufacturing industries, and also in the service industries.

Thank you very much.

PREPARED STATEMENT OF TIMOTHY C. BRIGHTBILL
PARTNER, WILEY REIN, WASHINGTON, DC

Written Statement of Timothy C. Brightbill[1]
Before the U.S.-China Economic and Security Review Commission
Hearing on Chinese State-Owned and State-Controlled Enterprises
February 15, 2012

I. INTRODUCTION

U.S. companies and industries are built on capitalism and free markets, all of which enjoyed undeniable and unprecedented global success in the 20th century. However, that success is now potentially threatened by the rising use of state power in global commerce. Indeed, "[t]he invisible hand of the market is giving way to the visible, and often authoritarian, hand of state capitalism"[2] – a disturbing trend with significant economic and security implications for U.S. companies who compete with China for business, whether in China, the United States or elsewhere in the world.

Particularly troublesome for free-market economies is the growing use of state-owned and state-supported enterprises, both within a country's borders and in global markets, including in the United States. China, in particular, has created massive state-owned and -controlled national champions that are designed to be competitive on the international stage. These state-owned enterprises ("SOEs") are instrumentalities of the state, subject to varying degrees of direction and control by the Chinese government, and are often protected from competition in their own market. They are motivated not only by economic concerns, but also by government objectives, including technology transfer, access to raw materials, job creation and geopolitical influence.

While the involvement of SOEs in the Chinese market is harmful enough, the growth of Chinese SOE investment abroad represents a new and growing threat to fair competition and the ability of U.S. producers to compete here and around the globe. Subsidized and otherwise advantaged by the Chinese government, these SOEs

[1] Mr. Brightbill is a Partner in the International Trade practice of Wiley Rein LLP in Washington, D.C., and an adjunct professor at Georgetown University Law Center. He is also a member of the U.S. Industry Trade Advisory Committee ("ITAC") on Service and Finance Industries. Mr. Brightbill represents clients on all aspects of international trade law and policy including import trade remedies, global trade policy and trade negotiations, at WTO litigation. This testimony represents the personal views of Mr. Brightbill and is not offered on behalf of any client or his firm.

[2] Adrian Wooldridge, *The visible hand*, The Economist (Jan. 21, 2012) ("*The visible hand*") at 5.

often do not operate based on market principles and therefore can introduce anti-competitive behavior and other market distortions where they invest. In addition, Chinese SOE investment and operations abroad force U.S. companies to compete directly against the Chinese government in our home and global markets, creating significant imbalances that harm U.S. workers and private companies competing in these markets.

II. THE RESURGENCE OF STATE CAPITALISM IN CHINA

While Chinese SOEs are not a new phenomenon, the degree of state involvement in economic activity is growing in certain sectors, as the Chinese government is increasingly pursuing ownership, control and direction of key industries and companies. The Chinese government continues to control the "commanding heights" of the economy, including ownership of major sectors such as banking, insurance, raw materials and steel. China's strategic plan for these and other "pillar" industries is to create massive state-owned and -controlled national champions that are capable of competing on the international stage. Pursuant to government-issued industrial policies, these SOEs are now expanding overseas with the full support of the Chinese government, to pursue government objectives.

A. Growing State Ownership and Control in China

After a brief period of economic liberalization in the 1980s and 1990s, the Chinese government has reasserted its power over its SOEs and various sectors of the economy. For example, in 2003, the Chinese government established the State-owned Assets Supervision and Administration Commission of the State Council ("SASAC") to exercise ownership rights over China's largest SOEs. SASAC enables the Chinese government to exercise considerable control over the commercial decisions of SOEs, including decisions relating to their strategies, management and investments.[3] China's recently issued 12th Five-Year Plan further demonstrates the government's continued and substantial involvement in the economy, providing for direct government ownership and control over certain key sectors of the economy. The plan explicitly states that one of its goals is to "uphold the basic economic system in which public ownership is the mainstay."[4]

SOEs now constitute 80 percent of the value of the Chinese stock

---

[3] *See* United States Trade Representative, *2011 Report to Congress on China's WTO Compliance* (Dec. 2011) ("USTR Report on China's WTO Compliance") at 59.

[4] Chapter 45 of Title XI in China's Twelfth Five-Year Plan (Reform in Different Areas, Improving Socialism Institution of Market Economy).

market, and the Chinese government is the biggest shareholder in China's 150 largest companies.[5] Many companies which are not wholly-owned by the government are nonetheless subject to state control. As the Commission has recognized, "[t]he state's influence over China's economy takes many forms and covers a whole spectrum of companies from fully state owned to those that are nonstate but maintain close ties to the government."[6]

B. China's "Going Abroad" Policy and Increasing Chinese SOE Investment in the United States

As the next step in its government-directed industrial strategy, China is accelerating its "Going Abroad" strategy, deploying its massive state-owned national champions overseas to further the government's objectives. First announced by the government in 1999, China's "Going Abroad" strategy is a government-mandated policy intended to strengthen the presence of Chinese companies abroad. The policy is mandated by government industrial plans at both the central and provincial government levels. Many of these policies identify which entities are to go abroad, and call for government subsidies and other support to enable these entities to do so. For example, the *2009 Revitalization Plan* encourages Chinese steel producers to "make exclusive investments or set up joint ventures abroad" and encourages "qualified backbone enterprises . . . to carry out resource exploration, development, technical cooperation and mergers and acquisitions . . . overseas."[7]

China's "Going Abroad" policy has been successful to date. In 2005, Chinese outward foreign direct investment ("FDI") totaled $10.2 billion; in 2011, that figure rose to nearly $73 billion.[8] Overall, Chinese companies have made foreign investments totaling approximately $443.2 billion.[9] Moreover, at least 80 percent of all Chinese outward FDI has been funded by SOEs.[10] The figure is likely much higher, as Chinese government statistics demonstrate that private enterprises accounted for

---

[5] *The visible hand* at 4. *See also* U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Nov. 2011) ("Commission's 2011 Report to Congress") at 40 ("there are more than 100,000 smaller companies that are owned or operated by provincial and local governments").

[6] Commission's 2011 Report to Congress at 40.

[7] 2009 Revitalization Plan.

[8] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at Chart 1.

[9] *See* the Heritage Foundation, *China Global Investment Tracker Interactive Map*, available at http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map.

[10] *The visible hand* at 15.

only 0.6 percent of all outward FDI from China in 2009.[11] The energy and power sectors and the metals sector continue to draw the largest investments from China. [12]

The Western Hemisphere is the most popular destination for Chinese investment outside of Asia, but China is only beginning to invest heavily in the United States.[13] Even so, Chinese SOEs have made several large U.S. investments in recent years. For example, in mid-2011, the state-owned Aviation Industry Corporation of China ("AVIC") acquired Minnesota-based Cirrus Industries, Inc., giving the Chinese aerospace company access to Cirrus' technology.[14] This latest acquisition came soon after AVIC's purchase of Continental Motors, an Alabama aircraft manufacturer, in late 2010.[15] Chinese SOEs have also shown interest in the U.S. energy sector, with the Chinese National Offshore Oil Company's purchase of a $2.2 billion stake in 600,000 acres of Texas oil and gas fields[16] and China Investment Corporation's acquisition of a 15 percent stake in AES Corporation, a U.S. power generating company.[17] A subsidiary of state-owned China National Petroleum Corporation owns 51 percent of INOVA Geophysical Equipment, a U.S. provider of land geophysical technology, as a result of a joint venture with ION Geophysical.[18]

---

[11] *See* Nargiza Salidjanova, Policy Analyst for Economic and Trade Issues, *Going Out: An Overview of China's Outward Foreign Direct Investment*, USCC Staff Research Report (March 30, 2011) at 6.

[12] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at 3-4.

[13] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at 3-4. *See also* Keith B. Richburg, *U.S. says it wants investment, but China remains wary*, Washington Post (Feb. 10, 2012).

[14] *See* Norihiko Shirouzu, *China to Buy U.S. Plane Maker*, Wall Street Journal (Mar. 3, 2011), available at http://online.wsj.com/article/SB10001424052748704728004576176243061806326.html; *Dewey & LeBoeuf Advises China Aviation Industry General Aircraft on Acquisition and Regulatory Approval of US Aviation Business* (July 4, 2011), available at http://www.deweyleboeuf.com/en/Firm/MediaCenter/PressReleases/2011/07/DeweyLeBoeufAdvisesChinaAviation.

[15] *Teledyne Technologies Agrees to Sell Teledyne Continental Motors to AVIC International* (Dec. 14, 2010), available at http://www.teledyne.com/news/tdy_12142010.asp.

[16] *See* Monica Hatcher, *China stakes claim to S. Texas oil, gas*, www.mysanantonio.com (Oct. 12, 2010) http://www.mysanantonio.com/business/local/article/China-stakes-claim-to-S-Texas-oil-gas-858329.php#ixzz1lpDXKbQs.

[17] *AES Announces Close of Transaction with China Investment Corporation* (Mar. 15, 2010), available at http://investor.aes.com/phoenix.zhtml?c=76149&p=irol-newsArticle&ID=1402516&highlight=.

[18] *See INOVA Geophysical and BGP Execute Successful High Productivity Vibroseis Project in Oman* (Apr. 19, 2011), available at http://www.prnewswire.com/news-releases/inova-geophysical-and-bgp-execute-successful-high-productivity-vibroseis-project-in-oman-120193189.html.

Finally, China has also begun investing in the U.S. steel industry. In January 2009, Chinese state-owned Tianjin Pipe Group Corp. ("TPCO") announced its plans to invest in the construction of a steel pipe plant near Corpus Christi, Texas, its first U.S. production operation.[19] In 2010, the fourth largest Chinese steel producer, Anshan Iron and Steel, announced plans that it was forming a joint venture with Steel Development Company to build up to 5 new steel plants in the United States.[20] Anshan is 100 percent owned and controlled by the central Chinese government and has received massive government subsidies. A number of Chinese government industrial plans explicitly identify Anshan as a recipient of extensive government support in order to strengthen its international competitiveness and to assist it in establishing operations abroad. In fact, Anshan itself made clear that its U.S. investment was part of the government's "Going Abroad" strategy.[21] While this investment has not moved forward, investments like it would pose serious competitive challenges in the U.S. market.

III. <u>CHINESE SOES POSE COMPETITIVE CHALLENGES IN THE UNITED STATES AND ABROAD</u>

Chinese SOE investment and operations in global markets may result in anti-competitive behavior and other distortions that adversely impact U.S. companies and workers. Many SOEs receive substantial subsidies from the Chinese government, including cash grants, below-market financing and other support, even in the worst economic conditions. As a result, these entities do not need to make a profit and have little incentive to make production, pricing or other business decisions based on market principles, giving them a significant advantage over their private sector competitors. Moreover, China's SOEs often operate at the direction of the government and for the purpose of advancing government aims, rather than in accordance with commercial principles.

The potential adverse economic and security impacts of SOE participation in the marketplace and investment abroad have been well documented. For example, the Organization for Economic Cooperation and Development ("OECD") has released a number of

---

[19] *China's TPCO plans build of $1B pipe mill in Texas*, MetalBulletin.com (Jan. 2, 2009). This investment was made possible by massive Chinese government subsidies. *See* Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 9, available at http://www.steelnet.org/new/new_body.html.

[20] *See* Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 9-11, available at http://www.steelnet.org/new/new_body.html.

[21] *Id*.

reports detailing the rise of SOE investment abroad and the related anti-competitive effects and market distortions that may result, both in the SOE's home market and in markets around the world. The OECD has concluded that:

> In most instances, SOEs enjoy privileges and immunities that are not available to their privately-owned competitors. These privileges give SOEs a competitive advantage over their rivals. Such advantages are not necessarily based on better performance, superior efficiency, better technology, or superior management skills but are merely government-created and can distort competition in the market.[22]

The various distortions caused by SOE investment and operations in global markets are discussed in further detail below.

A. Chinese Government Subsidies and Other Benefits Provide its SOEs with Unfair and Market-Distorting Competitive Advantages

Chinese SOEs often receive massive subsidies and other benefits from the Chinese government, which bestow an unfair competitive advantage on SOEs in their worldwide operations. As this Commission has documented, such subsidies are prevalent in China, and often at substantial levels.[23] Some of the most significant ways in which the Chinese government benefits its companies and distorts the global marketplace are described below.

- Direct subsidies: The Chinese government provides direct subsidies to its SOEs in the form of cash grants and/or capital infusions.[24] One example is the government's grant of RMB 50.9 billion to SOE Sinopec Corp. to cover the company's losses in 2008.[25]

- Preferential loans and access to finance: China's state policy banks and state-owned commercial banks have traditionally made loans based on political directives,

[22] *Competitive Neutrality in the Presence of State Owned Enterprises*, OECD, DAF/CA/PRIV(2010)1 (Apr. 2, 2010) ("April 2010 OECD Paper on Corporate Neutrality and SOEs").

[23] *See, e.g.*, Commission's 2011 Report to Congress at 40 (China's state-owned and state-controlled companies "receive massive government subsidies and are protected from foreign competition").

[24] *See* Andrew Szamosszegi and Cole Kyle*, An Analysis of State-owned Enterprises and State Capitalism in China*, prepared for the U.S. China Economic and Security Review Commission (Oct. 26, 2011) ("Analysis of Chinese SOEs and State Capitalism") at 20.

[25] Analysis of Chinese SOEs and State Capitalism at 20.

rather than creditworthiness or other market-based factors.[26] Government-owned banks in China frequently make loans to SOEs on preferential terms. As reported by *The Economist*, Chinese SOEs enjoy favorable interest rates on loans from state-owned banks, paying only 1.6 percent interest on such loans, while private companies are charged 4.7 percent interest – if they can access credit at all.[27] In fact, approximately 85 percent of China's $1.4 trillion in bank loans went to state-owned companies in 2009.[28] Such concessionary funding is often used to finance an active foreign acquisition strategy for SOEs.[29] Loans by China's policy banks also distort the market in industries not dominated by SOEs. In the solar manufacturing industry, for example, individual Chinese producers have received billions of dollars in loans and loan guarantees.

- Tax reductions and exemptions: Many Chinese SOEs benefit from preferential tax rates and exemptions from both the central and provincial governments in China. "The Chinese government has long used lower tax rates to reward firms for undertaking investments, procuring goods and services, and performing other activities that market incentives alone would not support."[30] U.S. regulatory filings for firms owned by Chinese SOEs demonstrate that "many SOEs and subsidiaries were beneficiaries of preferential tax rates."[31]

- Preferential access to raw materials and other inputs: The Chinese government also supports its SOEs and other domestic manufacturers by ensuring them adequate supplies

---

[26] *See* Stephen Lacey, *How China Dominates SolarPower*, The Guardian (Sept. 12, 2011), available at http://www.guardian.co.uk/environment/2011/sep/12/how-china-dominates-solar-power ("The [China Development Bank ('CDB')] was originally set up as a "policy bank," to operate as an arm of the Chinese central government... Now it… reports to China's national cabinet on certain policy issues, [allowing] the Chinese government to get involved in CDB activities and direct loans…").

[27] *The visible hand* at 15. The World Trade Organization ("WTO") recognized in 2010 that domestic private enterprises in China, as opposed to SOEs, were finding it more difficult to access credit from banks. *See* WTO, Trade Policy Review of China, Report of the Secretariat, WT/TPR/S/230 (Apr. 26, 2010) at 54, available at http://www.wto.org/english/tratop_e/tpr_e/tp330_e.htm.

[28] *The visible hand* at 7.

[29] *See* April 2010 OECD Paper on Corporate Neutrality and SOEs at 7; *The Corporate Governance of SOEs Operating Abroad*, OECD, DAF/CA/PRIV(2009)8 (Oct. 8, 2009) ("Corporate Governance of SOEs Operating Abroad") at 10.

[30] *See* Analysis of Chinese SOEs and State Capitalism at 45.

[31] Analysis of Chinese SOEs and State Capitalism at 45.

of low-priced raw materials. These and other inputs are often provided to SOEs at below market prices. In addition, China has imposed various export restrictions on steel-making raw materials and rare earth elements, even though China is the largest source of many of these materials. This causes supply crises for manufacturers around the world, while providing Chinese companies – such as those in the state-dominated steel industry – with an unfair competitive advantage. The World Trade Organization's ("WTO's") Appellate Body recently upheld a dispute settlement panel's finding that China had violated several of its commitments by imposing WTO-inconsistent export restrictions on raw materials, including bauxite, coke and zinc.[32]

- Preferential regulatory treatment: SOEs in China are often not subject to the same costly regulatory regimes as private companies, resulting in lower operating costs than their private competitors. Such preferential treatment includes: exemption from regulatory regimes such as antitrust enforcement, zoning regulations or disclosure regulations; preferences in government procurement; and preferential tax treatment, including tax exemptions, reductions or other tax-related concessions.[33]

All of these subsidies and other benefits artificially lower SOEs' costs and enhance their ability to sell at lower prices than their private sector competitors. Thus, the potential anti-competitive repercussions of government subsidies to SOEs include predatory pricing and raising rivals' costs.[34] In addition to lowering profits for private companies and potentially threatening their survival, "[p]redation or raising rivals' cost takes away the ability for [private] competitors to invest in increased research and development and limits their ability to roll out new products and services and processes that increase dynamic gains from innovation."[35] Beyond unfair cost

---

[32] *China – Measures Related to the Exportation of Various Raw Materials*, Reports of the Appellate Body, WT/DS394/AB/R, WT/DS395/AB/R, WT/DS398/AB/R (Jan. 30, 2012), available at http://www.wto.org/english/news_e/news12_e/394_395_398abr_e.htm.

[33] *See Competitive Neutrality in the Presence of State Owned Enterprises*, DAF/CA/PRIV(2010)1 (Apr. 2, 2010) at 6-7 and 20.

[34] April 2010 OECD Paper on Corporate Neutrality and SOEs at 6; Corporate Governance of SOEs Operating Abroad at 9-10.

[35] *Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options*, OECD Corporate Governance Working Papers, No. 1 (May 2011) ("May 2011 OECD Paper on Competitive Neutrality and SOEs") at 19.

advantages, some unprofitable SOEs, which in a free market would be driven out of business, "may enjoy outright exemptions from bankruptcy rules."[36] The OECD also notes the possibility for "cross-subsidization" of SOEs, which can occur where SOEs "charg[e] excessive revenues in certain 'lucrative' areas in order to be able to fund the public service obligations elsewhere."[37]

A number of additional anti-competitive effects result from the fact that control of an SOE cannot be transferred as easily as in privately-owned firms. These advantages include: some SOEs are not required to pay dividends or any return to shareholders; SOEs will be more inclined to engage in anti-competitive (and rarely profitable) exclusionary pricing strategies without fear of falling stock prices when losses are incurred due to the below-cost pricing; and SOEs' management will have less incentive to operate the enterprise efficiently as it is not subject to the threat of takeovers and is generally impervious to the disciplining effects of capital markets.[38]

Moreover, the asymmetric availability of information and lack of transparency that characterize state-dominated economies like China's can create market distortions. If SOEs have access to government information, including classified intelligence, while their private competitors do not, then these entities trade at what could be an unfair advantage, undermining market confidence.[39]

These anti-competitive effects essentially cause U.S. companies to compete in global markets with foreign governments, and all of their resources and power, rather than with similarly-situated privately-owned foreign companies. The resulting anti-competitive effects are experienced by companies in markets around the globe. Not surprisingly, in many cases, Chinese FDI into global markets has pushed out local companies, who are unable to compete with heavily subsidized Chinese SOEs.[40]

B. Case Study of Chinese Subsidies and Resulting Market Distortions: China's Solar Industry

China's renewable energy sector demonstrates the effects of

---

[36] May 2011 OECD Paper on Competitive Neutrality and SOEs at 6.

[37] May 2011 OECD Paper on Competitive Neutrality and SOEs at 8.

[38] April 2010 OECD Paper on Corporate Neutrality and SOEs at 7-8.

[39] Corporate Governance of SOEs Operating Abroad at 10-11.

[40] *See, e.g.*, Stanley Kwenda, *Zimbabwe: Chinese become unwelcome guests*, TradeMark Southern Africa (Jan. 9, 2012), available at http://www.trademarksa/org/news/zimbabwe-chinese-become-unwelcome-guests.

state capitalism in China and Chinese government subsidies at work. Over the past decade, China's solar industry has expanded at a phenomenal rate. In 2008, "China became the largest producer of solar panel cells in the world, shipping … roughly one-third of worldwide total [solar] cell shipments."[41] China remained the world's largest producer of solar cells in 2009 and 2010[42] and captured more than half of the global cell market for the first time in 2010.[43]

This rapid and unprecedented expansion was the direct result of the Chinese government's support for its solar energy industry, including its granting of an extraordinary range and amount of subsidies to the industry. Some companies in China's solar industry are SOEs; many others are effectively state-controlled because of close connections to the government, or because they are dependent on the government for subsidies.[44]

Moreover, Chinese producers of polysilicon – the major input into solar cells – are largely state-owned.[45] In fact, research conducted in China shows that, over the last decade, the Chinese government has created its own state-owned and -controlled polysilicon industry. Now, nearly all of the largest polysilicon producers in China are state-owned or -controlled. In the past, China procured much of its polysilicon from U.S. producers.[46] However, because of the industry's government

---

[41] Dewey & LeBoeuf LLP for the National Foreign Trade Council, *China's Promotion of the Renewable Electric Power Equipment Industry: Hydro, Wind, Solar, Biomass* (Mar. 2010) at 75.

[42] *See Why Solar Prices Will Continue Falling*, Hexun News (Apr. 18, 2011); Keith Bradsher, *China Leading Global Race to Make Clean Energy*, The New York Times (Jan. 30, 2010).

[43] *Asia Doubles Solar Silicon Factories, Pursuing Gain in Slump*, Bloomberg News (July 10, 2011).

[44] For example, CGN Solar Energy Development Co. is a subsidiary of SOE China Guangdong Nuclear Power Group. *See* Ucilia Wang, *China, finally, emerging as big market for solar demand*, www.gigaom.com (Nov. 22, 2011), available at http://gigaom.com/cleantech/china-finally-emerging-as-big-market-for-solar-demand; Marco Lui, *GCL-Poly Energy Enters Into Co-Operative Agreement With CGN Solar*, Bloomberg (Nov. 17, 2011), available at http://www.bloomberg.com/news/2011-11-17/gcl-poly-energy-enters-into-co-operative-agreement-with-cgn-solar.html. China's largest solar power plant developer, CECEP Solar Energy Technology, is an SOE. Sonal Patel, *U.S.-China Solar Trade Dispute Gets Thornier*, POWER (Jan. 1, 2012), http://www.powermag.com/renewables/solar/4280.html.

[45] For example, Yichang CSG Polysilicon Co., Ltd is a subsidiary of the China Southern Power Grid Company Limited ("CSG"), an SOE. *See* Yichang CSG Polysilicon Co., Ltd., *Company Profile*, http://www.csgpolysilicon.com/enwww/about.asp?ID=19; International Rivers, *China Southern Power Grid*, available at http://www.internationalrivers.org/node/3314. The China Investment Corporation ("CIC"), a wholly state-owned company, holds an interest in CGL-Poly Energy Holdings Limited. *See GCL-Poly sells $710 mln shares to China Investment Corp*, Reuters (Nov. 18, 2009), available at http://www.reuters.com/article/2009/11/19/gcl-cic-idUSHKG24700920091119; China Investment Corporation, *Overview*, http://www.china-inv.cn/cicen/about_cic/aboutcic_overview.html.

[46] *See, e.g.*, Greentech Media, *U.S. Solar Energy Trade Assessment 2011* (Aug. 2011) at 49.

ownership and other government support, polysilicon production in China has skyrocketed in the past five years,[47] and U.S. polysilicon exports to China are declining.[48]

China has aggressively pursued a national policy to support its SOEs and other Chinese companies in the solar industry. In 2005, the GOC enacted the *Renewable Energy Law* to "promote the exploitation of renewable energy."[49] The law established a national policy to encourage the use of solar and other renewable energy sources, and it "encourages economic entities of various ownerships to participate in the exploitation of renewable energy and protects the lawful rights and interests of the exploiters of renewable energy."[50] A number of other measures have been passed to strengthen government support for China's solar industry, many of which explicitly call for subsidies.[51]

The Chinese government has consistently furthered this national policy through the provision of various subsidies to its solar industry. From only January 2010 through September 2011, preferential loans and credit provided by state-owned Chinese banks to Chinese solar producers totaled nearly $41 billion[52]– an unprecedented amount, even for China. The central, provincial and local Chinese governments also provide a variety of tax exemptions, reductions and credits that directly benefit China's

---

[47] In 2009 alone, Chinese polysilicon production rose 300 percent from 2008 levels. *See* Coco Liu, *China to Restrict Polysilicon Production*, greentechmedia.com (Mar. 16, 2010), available at http://www.greentechmedia.com/articles/read/china-to-restrict-polysilicon-production/; Zachary Tracer and Joshua Fellman, GCL-Poly Plans to Boost Polysilicon Capacity Amid Oversupply, Bloomberg (Nov. 14, 2011), available at http://www.bloomberg.com/news/2011-11-14/gcl-poly-plans-to-boost-polysilicon-capacity-amid-oversupply.html.

[48] From 2010 to 2011, U.S. polysilicon exports to China decreased by nearly 60 percent. 2010 export data obtained from Greentech Media, *U.S. Solar Energy Trade Assessment 2011* (Aug. 2011); 2011 data based on official U.S. import/export statistics as reported by the U.S. International Trade Commission.

[49] *Renewable Energy Law of the People's Republic of China* (Feb. 28, 2005) at Art. 1.

[50] *Renewable Energy Law of the People's Republic of China* (Feb. 28, 2005) at Art. 4.

[51] For example, the June 2006 *National Medium- and Long-Term Program for Science and Technology Development* (2006 – 2020) sets forth goals for the renewable energy sector, with emphasis on developing "high-performance and low-cost solar voltaic cells" and establishing financial and tax policies to encourage research and development in the priority sectors. In September 2007, the National Development and Reform Commission ("NDRC") released the *Medium and Long-Term Development Plan for Renewable Energy in China* to "speed up the development and deployment of hydropower, wind power, solar energy, and biomass energy; . . . {and} increase market competitiveness." The plan directs local authorities to "allocate the necessary funds to support renewable energy development."

[52] Mercom Capital Group, *Loans and Credit Agreements involving Chinese Banks to Chinese Solar Companies since Jan 2010* (Sept. 25, 2011) available at http://mercomcapital.com/loans-and-credit-agreements-involving-chinese-banks-to-chinese-solar-companies-since-jan-2010.

solar producers.[53] In addition, the Government of China subsidizes export-oriented renewable energy producers. For example, to support the export of products listed in China's *Catalogue of Chinese High-Tech Products for Export*, which includes solar energy products, the Export-Import Bank of China provides export-contingent loans at preferential rates. In 2010 alone, new medium- and long-term official export credits from China amounted to $45 billion.[54]

Since its inception and throughout its rapid expansion, the Chinese solar industry has been heavily export-oriented,[55] selling subsidized Chinese cells and modules at extremely low prices in the United States, injuring the U.S. solar industry and distorting the entire global market for solar products. Moreover, given the massive government support for the solar industry as well as the government's mandate to go abroad, there is every indication that Chinese solar SOEs will further expand their global reach. In fact, state-controlled China National Offshore Oil Corp. recently closed a deal with Spanish solar equipment maker Isofoton SA to create a joint venture to develop solar power projects.[56]

C. Chinese SOEs Pose Strategic and Security Concerns

Because SOEs "often behave as instruments of Chinese foreign policy,"[57] SOE investments and operations in the U.S. market also raise national security and other strategic concerns. The primary motive of SOEs often is not merely economic, but rather to further the objectives of the government, whether it be to obtain advanced technologies, secure access to raw materials, maximize production output or achieve geopolitical influence.

---

[53] For example, the government of China provides preferential tax benefits to enterprises with foreign investment that are recognized as "high" or "new" technology enterprises or are established in "high" or "new" technology industrial development zones. China has identified new-energy and efficient energy-saving technology as "high and new" technologies. *See, e.g.*, LDK Solar Co., Ltd. 2010 Annual Report and Notice of General Meeting at 29 (July 22, 2010) ("In December 2009, Jiangxi LDK Solar was recognized by the PRC government as a 'High and New Technology Enterprise' under the [Enterprise Income Tax] Law and is therefore entitled to the preferential enterprise income tax rate of 15% from 2009 to 2011").

[54] Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2011) at 11, available at www.exim.gov/about/reports/compet/documents/2010_Competitiveness_Report.pdf.

[55] For example, in 2008, 2009 and 2010, Chinese solar cell producer Yingli Green Energy sold 97.5 percent, 95.5 percent and 94 percent, respectively, of its products outside of China. Yingli Green Energy Holding Co. Ltd. Form 20-F For Fiscal Year Ended December 31, 2010 at 17, available at http://ir.yinglisolar.com/phoenix.zhtml?c=213018&p=irol-sec.

[56] Yvonne Lee and Aaron Back, *China Reinforces Energy Supplies*, Wall Street Journal (Feb. 2, 2012).

[57] Analysis of Chinese SOEs and State Capitalism at 86.

Chinese SOE investments in critical manufacturing and/or defense industries in the United States are troubling, given the precarious nature of the U.S.-China diplomatic relationship. For example, the U.S. steel sector plays a critical role in national defense, and in building and maintaining critical infrastructure. SOE investment in our steel markets could provide foreign governments with direct access to, and information concerning, current and future U.S. infrastructure, energy and defense projects that may be critical to national defense. Moreover, as has been acknowledged by SOEs who attempted to enter the U.S. steel market,[58] such investments could provide foreign governments with potential new technologies in steel production.

In addition, according to the OECD, companies owned by foreign governments or SOEs can effectively act as "Trojan horses," serving as conduits of illicit technology transfers as well as outright espionage. The secrecy of certain U.S. law enforcement efforts could be compromised if such efforts involve the cooperation of companies (*e.g.*, banks or telephone operators) controlled by foreign governments.[59]

At the direction of the Chinese government, Chinese SOEs are also aggressively targeting natural resources through their outward foreign investment, causing concern as to the availability of non-renewable resources for the U.S. economy. "The top Chinese leadership has stated that SOEs will continue to be the main actors in China's ['Going Abroad'] policy, and that China will use its massive foreign exchange reserves to fuel this overseas expansion, especially targeting energy and natural resources."[60] With regard to energy in particular, it is critically important for the United States to maintain its own domestic renewable energy industries and ensure that it does not become dependent on China to fulfill such needs, especially given that the United States already depends on foreign countries for fossil fuels to sustain our non-renewable energy needs. Thus, the Chinese government's control and direction of its SOEs poses a unique set of security and strategic concerns for the United States.

---

[58] When Anshan Iron and Steel Group, a company wholly owned and controlled by the Chinese government, proposed to invest in the U.S. market, several of Anshan's justifications for the investment derived from the Chinese government's industrial policies, including acquiring advanced technology and returning the technology to China. *See* Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 12-13, available at http://www.steelnet.org/new/new_body.html.

[59] Corporate Governance of SOEs Operating Abroad at 8.

[60] Analysis of Chinese SOEs and State Capitalism at 89.

D. Competitive Challenges for U.S. Companies Operating Within China

Most of the above-noted distortions created by China's state capitalist system and SOE involvement in the global marketplace adversely impact the competitive environment in China as well, making it more difficult for U.S. companies to compete on a level playing field in that country. Indeed, the provision of subsidies and other benefits, access to concessionary financing, preferential regulatory treatment, and other privileges and immunities granted to SOEs provide these entities a competitive advantage in their own home market over their private sector competitors. These privileges and immunities are often reinforced with discriminatory market access and government procurement policies that serve to protect favored industries and national champions.[61] Indeed, China has implemented policies that discriminate against certain imported goods, in derogation of its WTO obligation to provide treatment no less favorable than that accorded to domestic like products. China has also restricted foreign investment in certain key industries.

1. Foreign Investment Restrictions in China

China has long restricted foreign investment into its economy, and often uses its SOEs to implement such policies. As noted by USTR, "the Chinese government has… issued a number of measures that restrict the ability of state-owned and state-invested enterprises to accept foreign investment, particularly in key sectors."[62] For example, China imposes various hurdles to foreign investment in its largely state-owned steel industry. China's 2005 *Policies for Development of Iron and Steel Industry* ("Steel Policy") forbids foreign companies from owning a controlling stake in Chinese steel producers, stating: "For any foreign investment in the iron and steel industry of China, foreign investors are 'in principle' not allowed to have a controlling share."[63] Any foreign investment project in the steel industry that is permitted must first be approved by the Ministry of Commerce, the State Development and Reform Commission ("NDRC"), SASAC, and the China Securities Regulatory Commission (if the investment involves a Chinese listed company), and it must be registered with other relevant authorities.

---

[61] Robert D. Hormats, *Ensuring a Sound Basis for Global Competition: Competitive Neutrality*, DipNote: U.S. Department of State Official Blog (May 6, 2011).

[62] USTR Report on China's WTO Compliance at 61.

[63] 2005 Steel Policy at Art. 23. This restriction is further corroborated by USTR, which concludes that "foreign investors are not allowed to have a controlling share in steel and iron enterprises in China." *2010 National Trade Estimate Report on Foreign Trade Barriers: China*, U.S. Trade Representative at 3.

Such policies have resulted in a steel industry in China which is predominantly state-owned, with the government owning the vast majority of shares in almost all of China's major steel producers.[64] As of 2009, more than 95 percent of the production of the top 20 steel groups in China was subject to some government ownership, and 16 of the top 20 steel groups were 100 percent owned and controlled by the government.[65]

In many sectors where foreign investment is not completely prohibited, the Chinese government imposes various regulations which otherwise hinder foreign investment. USTR found that "China has added a variety of restrictions on investment that appear designed to shield inefficient or monopolistic Chinese enterprises from foreign competition."[66] For example, China continues to impose technology transfer requirements as a condition of foreign investment in many Chinese sectors, despite its WTO commitment not to do so.[67] The government of China continues to exercise control over technology transfers in its review of joint venture applications (pursuant to the *Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*), as well as in the government's involvement in contract negotiations between Chinese SOEs and foreign investors.[68]

2. The Role of SOEs in Chinese Government Procurement

Domestic industries in China, and SOEs in particular, enjoy an unfair competitive advantage in China's large and potentially lucrative government procurement market. China has still not acceded to the WTO's Government Procurement Agreement (despite commitments made upon its WTO accession), and USTR notes that China "is maintaining and adopting government procurement

---

[64] The Chinese Government's 10th Five-Year Plan for National Economic and Social Development established the framework for state ownership of the steel industry by requiring that the "state must hold a controlling stake in strategic enterprises that concern the national economy." Government of the People's Republic of China's Report on the Outline of the Tenth Five-Year Plan for National Economic and Social Development (delivered at the Fourth Session of the Ninth National People's Congress on March 5, 2001).

[65] *See The Reform Myth: How China is Using State Power to Create the World's Dominant Steel Industry*, Wiley Rein, LLP (October 2010) at 6-8.

[66] USTR Report on China's WTO Compliance at 68.

[67] *See* WTO Working Party Report on the Accession of China at ¶ 203 ("The allocation, permission or rights for investment will not be conditional upon performance requirements set by national or sub-national authorities or subject to secondary industrial compensation including specified types or volumes of business opportunities, the use of local inputs or the transfer of technology").

[68] *See, e.g.*, *Regulations for the Implementation of the Law on Sino-foreign Equity Joint Ventures* (2001) at Chapter VI, available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=51062.

measures that give domestic preferences."[69]

Over 60 percent of Chinese government procurement is made through domestic companies, including state-owned or -controlled enterprises.[70] There are several reasons for SOEs' substantial advantage in Chinese government procurement. First, the government of China indicates that "most procurement… is conducted by local governments, which may be predisposed to favor local SOEs who contribute revenues to local coffers."[71] In addition, SOEs have an advantage, especially over foreign competitors, because of the close relationships between the management of SOEs in a locality with local government decision makers. Furthermore, many government procurement opportunities in China are in SOE-dominated industries and, of course, the government has a vested interest in the success of SOEs.[72] Moreover, once SOEs obtain a government procurement contract in China, they are more likely to conduct any related sub-contracting through other SOEs. Thus, China's government procurement system is another means by which the government discriminates against foreign companies, including U.S. companies, in favor of its state-owned and domestic enterprises.

In sum, the increasing involvement of SOEs in markets around the globe threatens to undermine free-market principles and has significant implications for the U.S. and global economies. The policies and actions of the Chinese government, including its support for SOEs, continue to distort world trade and impose tremendous economic costs on the United States, its companies and its workers.

IV. POLICY OPTIONS FOR ADDRESSING THE COMPETITIVE CHALLENGES POSED BY CHINESE SOES

While the United States encourages foreign direct investment, and should continue to do so, the growing involvement of Chinese SOEs abroad presents unique challenges that can harm competitiveness in U.S. and world markets if left unaddressed. The potential for anti-competitive behavior and other distortions will only increase if state actors are allowed to operate abroad without restriction based on their government's direction and funding.

Though a number of countries have implemented mechanisms to

[69] USTR Report on China's WTO Compliance at 63-64.

[70] Analysis of Chinese SOEs and State Capitalism at 59.

[71] Analysis of Chinese SOEs and State Capitalism at 57.

[72] Analysis of Chinese SOEs and State Capitalism at 57.

discipline SOE investment,[73] additional work is required to confront the growth of Chinese SOE investment abroad. There are currently no adequate tools to address the growth of SOE participation in global markets. Nor are there adequate U.S. laws or mechanisms in place to ensure a level playing field when Chinese and other foreign SOEs engage in commercial activity in the U.S. market. Indeed, while much of the focus has been on ensuring fair treatment and a level playing field in China and other global markets, of equal or even greater importance is the potential adverse impact of SOE investment in the U.S. market.

Most recently, members of the business community have been working with the U.S. government to address these issues in the context of the Trans-Pacific Partnership ("TPP") Agreement. These efforts include establishing new and binding commitments in the TPP Agreement that effectively address the potential anti-competitive effects stemming from SOE investment in global markets. As the TPP Agreement is being touted as the model trade agreement for the twenty-first century, the United States should ensure that tough disciplines on SOE behavior are included – it should not allow further weakening of the SOE provisions. In particular, the United States should insist on language requiring that SOEs investing or operating in the markets of other signatories act based on commercial considerations and that SOEs do not receive subsidies or other benefits from their governments that unfairly advantage them with respect to an investment abroad. While China is not subject to the TPP Agreement, it covers a number of countries in which the state is playing a growing role in commercial activity. The agreement may also serve as a model for future agreements that include China.

Other potential steps to confront the increasing involvement of Chinese SOEs in the U.S. and global markets include the following:

- Continue to address the issue of SOEs through multilateral fora such as the OECD and the WTO. For example, the United States could continue to support the OECD's work on these

[73] These mechanisms include the concept of "competitive neutrality," whereby state-owned and -controlled entities engaged in commercial activities are disciplined by market forces. The Australian Government introduced such a "competitive neutrality" policy in 1995, with the goal of removing market distortions caused by state-owned businesses. Canada has both a national security review as well as a "net benefit" review, which ensures that foreign investment will be a "net benefit" to Canada (including whether foreign SOEs will adhere to Canadian standards of corporate governance and whether the entity will continue to operate on a commercial basis after the SOE acquisition or investment).

issues. In addition, USTR should be more aggressive in pursuing a case at the WTO against China for violating its commitments regarding government intervention in the operations of its SOEs.[74]

- Continue to pursue a coherent policy with respect to reducing potential anti-competitive effects of SOEs through model Bilateral Investment Treaty language, Free Trade Agreements, and other bilateral and multilateral agreements. This would include ensuring that SOEs are included as part of China's commitments upon joining the WTO Government Procurement Agreement.

- Advocate for an OECD agreement that establishes and enforces guidelines or "best practices" to ensure that SOEs operate based on commercial considerations. The arrangement could be modeled after the Santiago Principles (regarding Sovereign Wealth Funds) and the guidelines themselves could be similar to the OECD "Guidelines on Corporate Governance of SOEs."

- The United States should also consider heightened review for incoming investment by state-owned and state-controlled enterprises. Such a review could be in the form of an economic benefit test (*i.e.*, Canada) or could ensure that SOEs are abiding by an established set of rules (*i.e.*, the OECD Guidelines). The review could be designed to ensure that SOEs investing and/or operating in the United States act solely based on commercial considerations and that such SOEs do not receive subsidies or other benefits from their home government that provide them unfair advantages over their U.S. competitors. To target SOEs that operate with significant levels of government support, the provision also could be narrowly tailored to cover only SOE investments from non-market economy countries.

Such efforts to address issues related to SOE investment abroad are all the more important given the recent WTO Appellate Body decision relating to whether SOEs should be considered public bodies for purposes of the CVD law[75] – a decision which raises

[74] Among other things, China committed that it "would not influence, directly or indirectly, commercial decisions on the part of state-owned enterprises." *See* WTO Working Party Report on the Accession of China.

[75] *See United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China*, WT/DS379/AB/R, World Trade Organization (Mar. 11, 2011). The Appellate Body found that government ownership alone is insufficient to establish that an entity is a "public body" for purposes of the CVD law. The Appellate Body concluded that, in considering whether an entity is a public body, an investigative authority must

concerns about the ability to use traditional trade remedy laws to confront unfair trade practices by SOEs.

V. CONCLUSION

By making its SOEs artificially competitive in world markets, the Chinese government has disadvantaged market-oriented producers around the globe, including those in the United States. If these SOEs and their subsidiaries continue to expand their presence overseas to compete in private markets, they are likely to further distort global markets and cause additional harm to U.S. companies and their workers.

While we should not seek to restrict market-based foreign investment, the United States should increase efforts to address the potential market-distorting affects of Chinese SOEs in the U.S. and global markets. Such efforts will ensure that private companies in the United States are able to continue operating in accordance with free market principles.

consider whether the entity exercises authority vested in it by the government for the purposes of performing functions of a governmental character. *See id.*

HEARING CO-CHAIR WESSEL: Thank you.

Dr. Gordon.

STATEMENT OF DR. DAVID F. GORDON
HEAD OF RESEARCH AND DIRECTOR, GLOBAL MACRO ANALYSIS
EURASIA GROUP, WASHINGTON, DC

DR. GORDON: Thank you very much, and thank you, Chairman Shea, and members of the Commission for inviting me here today, and I also commend you for your leadership and attention to this issue, which is of critical strategic and economic importance to the United States.

The timing of today's hearing is especially appropriate as China's next leader, Xi Jinping, is currently in our country with an "open investment environment," quote-unquote, part of his visit's agenda.

My submitted testimony outlined the scale and the scope of the issue at hand. What I'd like to do in my oral remarks, and I broadly agree with what my colleague to my right has just laid out, is make a few distinct points about the nature of SOEs, the political trajectory around this in China, and then offer a few ideas for U.S. policymakers as they struggle to balance national security and trade priorities and the promises of inbound investment and the imperatives of employment growth here in our country.

My first point is that I think that the Chinese state's involvement in the economy and in the market has actually markedly increased since the financial crisis, that since 2008, that I think there's a clearer trajectory in China than what we saw in the years leading up to the crisis.

This is partially a direct result of the $600 billion stimulus that was generated in response to the financial crisis, and government funds and bank loans flowed overwhelmingly to SOEs, bolstering their balance sheets and squeezing private firms, particularly small and medium domestic enterprises.

Much of the allocated stimulus went to the nine "crisis-stricken" and pillar industries dominated by SOEs--electronics, petrochem, metallurgy, steel, auto, light industry, textiles, shipbuilding, and telecoms.

The support severely diminished and continues to diminish the possibilities of foreign investment in these sectors. Under the guise of consolidation, SOEs exploited the stimulus to acquire smaller private sector competitors, many of whom suffered in the global economic slowdown. So what we had in China was a resulting reduction in competition and a restriction of the investment environment, both for foreign competitors to SOEs, but also for private firms inside of China, with the policies of both the central government in Beijing and local and provincial governments, both explicitly and intentionally buttressing these trends.

Second point is that I think the problem here isn't just SOEs, and many nominally private Chinese firms, particularly national champions, basically present challenges that are not fundamentally different to SOEs. For example, they have direct and official telephone links and reserved board seats for Communist Party members, and, as my colleague said, a lot of direct state investment even in the private sector.

So there is a nexus of influence here, not only to official SOEs, but also to a wide range of national champion firms that are nominally private, and if you look at the familial connections between the executives and directors of these private firms, they're very closely bound up with the top tiers of influence and power in the Communist Party.

In sum, China, since 2008, has become less market focused, less private sector friendly, and this has significant implications, I think, for understanding and combating the challenges that Chinese SOEs pose to the United States.

As we've heard, China's SOEs have gone out into the world in a substantial degree, but I would emphasize here that this is a challenge and an opportunity, that the Chinese government itself does not have anything like full control over this. They have tried and failed to set up regulatory mechanisms to manage this, and I think that as I look at Chinese firms' behavior overseas, you're increasingly getting situations that are diplomatic challenges for China.

So I think the outward investment element here is both a strategic challenge and a commercial challenge for the United States, but it also poses some opportunities for the United States here.

Let me just conclude with a couple of recommendations. The first is I think that in terms of how we talk about state-owned enterprises and national champions, I think it would be very useful for U.S. government and for American firms and interests more generally to talk about the competitive disadvantages, both to foreign investors, but also inside of China itself.

There is a lot of opposition in China to these oligopolistic and monopolistic arrangements, and those can be highlighted, I think, to our benefit.

Second, the U.S. needs to continue to focus on the state-to-state arena for resolving commercial and legal disputes, as China's weak and pliant legal regime, I think, really makes effective avenues for investor state redress essentially nonexistent despite some minor progress over the years.

Third, I think it would behoove us frankly to recognize and respond to some Chinese requests. For example, CFIUS, I think is the gold standard for depoliticized vetting of foreign investment, and acceding to a request for more transparency, it would not change this.

Finally, I think that infrastructure is an area that is potentially ripe for testing the Chinese investment opportunity and whether we can find a pathway forward for inward investment that is mutually beneficial, both to Chinese firms and to American interests.

I think in thinking about this, a useful, but not entirely apposite, analogy is the way in which we cajoled Japanese investment into U.S. businesses, infrastructure, and key industries to mollify our own trade disputes and to improve employment prospects here, remembering, of course, that the businesses in the Japanese case were privately owned.

Thank you very, very much.

PREPARED STATEMENT OF DR. DAVID F. GORDON
HEAD OF RESEARCH AND DIRECTOR, GLOBAL MACRO ANALYSIS
EURASIA GROUP, WASHINGTON, DC

Testimony of
Dr. David F. Gordon
Head of Research and Director, Global Macro Analysis
Eurasia Group
Washington, DC
Thursday, February 15, 2012
11:15 AM

The Competitive Challenges Posed by China's State-Owned Enterprises

"We have one important piece of experience of the past 30 years: That is to ensure that both the visible hand and invisible hand are given full play in regulating the market forces."
-Chinese Premier Wen Jiabao

Chairman Shea, Vice Chairman Reinsch, and distinguished members of the Commission, thank you for inviting me here today. My name is David F. Gordon and I am Head of Research and Director of Global Macro Analysis at Eurasia Group, the global political risk analysis firm. Prior to Eurasia Group, I worked in the US government for nearly two decades, culminating in service as Director of Policy Planning under Secretary of State Condoleezza Rice.

Thank you for your leadership on and attention to this issue, which is already of critical strategic and economic importance to the US, and will be even more so in the coming years. The timing of today's hearing is especially appropriate, as China's next leader, Xi Jinping, is currently in the US lobbying for a more open investment environment. I will begin my testimony by outlining the scale and scope of the issue at hand.

China's state-owned enterprises (SOEs) present significant strategic and industrial challenges to US firms and the US government. Beijing has redoubled its efforts to build its companies into globally powerful entities in established and emerging industries. Substantial state support skews the competitive landscape for US companies and complicates US industrial and business policies both inside and outside the People's Republic. The challenge is most severe in China's domestic market, in which the US government can do little to protect US firms from Beijing's vast array of preferences for domestic industry. Yet the challenge extends far beyond China itself. As Chinese firms ascend the value chain and become industry leaders, their presence is increasingly felt in global markets. This will frustrate US firms facing unequal competition from Chinese competitors. It also presents economic and strategic opportunities for the US government and US firms as countries around the world seek to avoid dependence on Beijing. The next frontier for China's SOEs is the US market, where US policymakers will struggle to balance between national security and trade priorities on the one hand, and the promises of inbound investment and employment growth on the other.

What is a State-Owned Enterprise in China?

SOEs are a defining feature of the Chinese economy. Yet despite their prominence, Chinese SOEs are enormously diverse in scope, scale, and influence, and accounting for this diversity is crucial in accurately describing the challenges that they pose for the US. The term “SOE” itself refers to a vast array of public, semi-public, and even nominally private enterprises, all of which benefit enormously from government support and many of which have expanded their profile and influence in the Chinese economy in recent years. Such “sub-sovereign” actors sit at the nexus of the state and the market, but their relationship with the state (or, for that matter, the market) is not always clear or uniform—and neither is the ability of the central government to influence their behavior. Indeed, even the largest and most powerful SOEs have in some cases flatly contradicted Beijing’s broader policy goals. Assuming unanimity among the SOEs and their manipulability by Beijing is a mistake that obscures their true nature.

The most prominent SOEs are the centrally administered SOEs, companies operated by China’s central government, often as the majority owner (though with subsidiaries listed in Hong Kong). These state-administered SOEs, which comprise some of China’s largest companies, are distinct from but related to the thousands of locally-administered, smaller SOEs sprinkled throughout the country. All of these companies, large and small, are explicitly funded and administered by the Chinese government.

The behemoths—first among China’s sizable slate of SOEs —are Sinopec, CNPC, and CNOOC, which collectively comprise the national oil companies (NOCs). Undoubtedly, the state exerts sizable influence over the behavior of the NOCs and other major SOEs like them: the bureaucracy intervenes in domestic pricing practices and has power over crucial personnel appointments. Both Sinopec and CNPC, however, retain power and influence commensurate with their former status as state ministries—a higher rank in the Chinese political hierarchy than the State-owned Assets Supervision and Administration Commission (SASAC), the central authority that nominally oversees them. As a result, the NOCs are in some cases able to contravene the central government in Beijing. For instance, despite a veneer of coordination surrounding China’s outbound investment strategy—which has rapidly accelerated since 2009—China’s NOCs have in a number of cases actually bid against each other for new oil extraction projects in various parts of the globe.

Equally important as the SOEs, however, and presenting a comparable—and in some ways identical—challenge are the ostensibly private firms that Beijing supports explicitly or implicitly as “national champions.” Indeed, connections between many large indigenous firms and the government are incredibly murky in China. The true ownership structure of many enterprises is opaque; many businesses—and their owners—intentionally obfuscate their status. Literally thousands of firms in China turn to state support for policy incentives and financing channels. This is particularly true at local levels, at which a tremendous amount of complicity exists between bureaucrats and private enterprise.

In part, the state’s industrial policy goals drive this complicity. Beijing is dedicated to building “national champions” and promoting domestic innovation. Yet the government does not clearly delineate its support among the nation’s thousands of public and private companies. Instead, it provides generous and plentiful tax breaks and political protection for firms aligned with Beijing’s broader goals. This comprises the so-called “indigenous innovation” program: an industrial policy that seeks to catapult Chinese firms into the ranks of high-end manufacturing and global technological competitiveness. The dearth of internationally renowned Chinese brands and Chinese technologies is of great concern for the leadership, and an emphasis on domestic innovation has intensified in recent years. China’s government offers significant support to industries deemed strategic, including aviation, autos, heavy machinery, steel, textiles, equipment manufacturing, petrochemical, shipbuilding, light industrial manufacturing, electronics and information technology, non-ferrous metals, and logistics. In all these industries, regulators favor powerful SOEs and strong domestic private-sector firms alike through standards-setting, generous financing terms well below commercial lending rates, and preferences in government procurement.

Given the financial incentives involved, many private Chinese firms dedicate themselves to fulfilling the state's initiatives in the hopes of winning preferential subsidies or receiving a formal designations as "national champion," which brings with it even more support in the form of a overwhelmingly favorable regulatory and tax environment. Domestic industry groups, mostly dominated by major Chinese firms, have also become more influential in policymaking and thereby better positioned to slant domestic regulatory policy in their favor (a phenomenon often termed "regulatory capture"). The underappreciated irony is that these developments subject not only foreign firms but also many smaller Chinese private sector companies to competitive disadvantages in the China market. In fact, powerful SOEs and private-sector national champions with more substantial resources to devote to R&D and defending market share squeeze many smaller Chinese private firms out of the market. Indeed, in China, the pathway to profitability very often has less to do with business operations than with successfully obtaining state support.

Underpinning this complicity between the state and industry is a weak and pliant legal regime. In China, economic reforms have outpaced political and legal reforms. This quite rightly fosters public and investor distrust in the Chinese legal system. More importantly for the purpose of SOEs, however, it creates a void for brokering economic and business outcomes that the state is more than happy to fill. Private and foreign firms are left with little recourse: local courts generally yield to the preferences of local authorities and make politicized judicial decisions. China has made efforts to improve its legal regime, as it is well aware of the dilatory effects of a broken legal system on China's attractiveness as a foreign investment destination. But adjustments remain modest and the ruling Communist Party keeps tight control of the judicial system. The overall environment, then, has actually worsened for foreign firms, even as the legal regime itself has improved incrementally.

In sum, the Chinese government explicitly owns many firms. But these firms do not necessarily doing the government's bidding—at least not always. Meanwhile the true ownership of some other Chinese firms is simply unknowable. And among those that are nominally private, many of them still seek to tie closely to the government in the hopes of winning favoritism and financial support. This tumultuous system—or, more truly, complex web of systems—presents an extremely vexing policy dilemma for US policymakers.

The Future of SOEs in China

The question is whether the Chinese government will remain willing to manipulate the domestic market and nurture SOEs over time. Two major trends in China today strongly suggest that the trend toward state control may be lasting. First, the government's heavy-handed and interventionist response to the 2008 global financial crisis raises the possibility that Beijing will continue to strengthen SOEs at the expense of private enterprise over the longer-term. Second, a surge of popular and economic nationalism among the Chinese public—both organic and deliberately inculcated by the regime—has fueled the rise of SOEs and national brands. That will prove a lasting motivation for the government to stay involved in picking domestic winners and losers, and in helping its own firms outcompete foreign players.

The financial crisis and SOEs

Unquestionably, Chinese recovery from the financial crisis occurred at the expense of the domestic private sector. Government funding bolstered the balance sheets of state-owned companies and squeezed private firms—especially small and medium-sized companies. Much of the allocated stimulus went to state-owned or state-affiliated enterprises, especially in the nine “crisis-stricken” industries strategically targeted for support: electronics, petrochemicals, metallurgy, steel, automotive, light industry, textiles, shipbuilding, and telecommunications. This support severely diminished, and continues to diminish, the possibility of foreign gains in these sectors. The funding also emboldened and enabled SOEs to acquire smaller private sector competitors, many of which suffered in the global economic slowdown. The resulting consolidation and reduction in competition restricted the investment environment for foreign companies competing with SOEs and powerful private firms, with the policies of central and local governments explicitly and intentionally buttressing these trends.

Economic nationalism

Beijing has traditionally felt overreliant on foreign investment while its domestic players have lagged in technology and international managerial competence. The government has accordingly begun shifting policy to favor the development of domestic firms, and employs nationalism as a political and economic instrument to justify its initiatives. As a result, the investment environment for foreign firms in China is increasingly challenging. Technology transfer has become a frequent precondition for foreign investors’ participation in the Chinese market. Beijing has also identified and virtually closed to foreign investment a number of strategic sectors, including telecom, aviation, shipbuilding, oil/petrochemicals, and steel. And the government has stoked fervor over foreign acquisitions to block the purchases of domestic companies.

What comes next?

The most likely scenario in the short term is that Beijing continues to offer substantial support and protection to strategic industries and maintains a pivotal role in capital allocation for both private and public enterprises. This will be a great competitive challenge for US firms, especially in high-technology industries. Indeed many US firms in a wide swath of industries have systemically underestimated the speed and strength with which state support has enabled competition to emerge in their space. For now, many US firms maintain their competitive edge in international markets because they can innovate technologically in ways that Chinese firms are unable to do themselves. The competitive threat is growing, however, and the overall environment in China worsening for multinational companies.

Over the longer term there is reason to be more optimistic: Beijing will be compelled to buttress small-and medium-sized private enterprise within China because the Chinese economy will require those entities for continued job growth. And given their innovative edge and more efficient use of capital, both domestic and foreign private firms maintain intrinsic advantages over the SOEs. But the Chinese economy will require significant readjustment before Beijing fully comes to terms with these realities.

Outlook for US Policy and US Industry

The biggest challenge is in the China market

The biggest challenge for US industry, and thus for the US government, is the lack of a level playing field within China as domestic Chinese firms benefit from massive state support. The Chinese government continues to favor domestic enterprises through financial and regulatory incentives and by tolerating weak enforcement of intellectual property rights (IPR) protections. In recent years Beijing has outlined expansive plans for new regulatory and direct fiscal incentives for a host of high-end manufacturing and technology-oriented sectors in which US industry currently has a global advantage, including but not limited to nuclear power, aircraft, automobiles, medical devices, and agricultural equipment. Beijing also maintains broader clean and renewable energy development goals that help Chinese firms compete in industries increasingly seen as major potential drivers of employment and growth in the US. And within China IPR enforcement will remain weak, and the avenues for IP leakage are proliferating—driven by an increased willingness by Beijing to set standards and mandate technology transfers for investment approval.

The preferential treatment that large domestic players receive is altering the competitive landscape for foreign companies in China, particularly in high-technology sectors. Chinese state-owned companies continue to lobby the government to restrict market entry for foreign firms and channel funding to domestic technology research, citing fears of overcapacity and the need to build indigenous expertise. One particularly troubling policy for foreign companies is restricted access to China's government procurement market. Last year Beijing promised to modify this practice, but implementation of that promise is not evident as of yet.

In this environment, protection of the intellectual property (IP) of US firms in the China market is unlikely to improve substantially. Poor enforcement of existing nationwide regulations at the local level will continue to be the major concern. At the same time, regulators will more often impose on foreign firms investment criteria that mandate technology transfers or cooperation with domestic industry. Already many foreign investors struggle with the government's increased willingness to impose standards for domestic markets, especially in high-technology fields. To meet the standards, foreign firms are often forced to submit detailed information on production processes. This regulatory hurdle is a major source of IP leakage and will continue to be so for the foreseeable future. Beijing is unlikely to seriously bolster its IP protection regime until domestic Chinese industry demands it—driven by its growing capability to drive innovation on its own.

SOEs are increasingly competitive globally as well

Beijing not only empowers its state-owned enterprises domestically. It is also determined to transform many of them into globally competitive "national champions." This goal lies at the heart of Beijing's favored lending rates and encourages consolidation in targeted industries. Beijing now allows these firms to borrow from the state's massive foreign exchange reserve holdings to conduct outbound purchases. Conveniently, the goal of promoting "national champions" also aligns with China's energy security goals. Chinese firms in key sectors from petroleum to metals to shale gas are finding growing success in pursuing outbound investments in developing and developed markets.

But Beijing's outbound engagement has raised a new set of problems for China. Many Chinese outbound investments in the developing world have relied on quid-pro-quos related to infrastructure and other development deals. Striking these kinds of deals, however, is increasingly difficult for

China. Host governments and populations, most notably in Africa, have begun to push back against Chinese firms’ employment policies and perceived exploitations. Meanwhile Beijing has struggled to coordinate the activity of its own firms abroad, and to align that activity with the government’s diplomatic goals. In recent months Beijing has attempted to manage corporate interests and avert mounting economic losses in overseas ventures. These efforts will yield limited results: some state-owned firms will become more risk-conscious. Yet oversight of outbound investments will remain fragmented, like a symphony without a conductor. And many firms, especially nominal or actual private companies, will actively disregard cumbersome approval processes and government guidelines, creating additional political headaches for Beijing.

Specifically, even though China's political elite support outbound investments and view them as integral to their firms' development, Chinese policymakers are increasingly aware that greater commercial exposure overseas will require greater involvement in global affairs—a responsibility that Beijing would prefer to avoid. In the first two months of this year alone, investments in Sudan and Iran have demonstrated the need for a careful balance between corporate goals and diplomatic priorities. It will become more and more difficult for China to remain diplomatically agnostic as its firms expand and diversify their commercial interests internationally.

This presents economic and strategic risks for the US, but also significant opportunities. Undoubtedly, Chinese SOEs will become more globally competitive in ways that threaten US competitiveness. Chinese overproduction will continue to deluge new and emerging industries. At the same time, stronger Chinese competitors will gain global market share in established industries such as telecom and railways. Yet China’s missteps, and the growing resistance in the developing world to perceived exploitation, will create opportunities both for US firms and for US diplomacy. Already, China’s neighbors in Asia are seeking closer strategic and economic ties with the US to offset China’s influence. Burma, in which a government long coupled to Beijing for economic and strategic support and outside investment is now pursuing an aggressive engagement strategy with Washington, is a perfect example. Those trends will emerge outside of Asia as well.

The next frontier is the US domestic market

The nascent policy dilemma surrounding all of these issues is what role China’s SOEs will seek and be allowed to play in the US domestic market. The US, despite recent economic weakness, still maintains the world’s largest and most attractive consumer market. We have robust domestic energy and commodity resources with positive growth prospects, like coal and unconventional hydrocarbons, that present enormous potential profits for the companies involved in extraction. Our open capital markets and regulatory structures underpin and support our attractiveness as an investment destination for foreign firms.

Chinese SOE investment in the US remains nascent. Available data from private research firms shows just $10 billion of cumulative SOE investment into the US market—a paltry sum mostly focused on fossil fuels and financial services. Over the last decade, reputational risk, especially the possibility of running afoul of the Committee on Foreign Investment in the United States (CFIUS), has deterred would-be Chinese investment. Yet many Chinese SOEs, in a wider array of industries, are cash-rich. The goods they produce are becoming globally competitive. These firms will seek opportunities within US borders, and US household and corporate consumers will be interested in their products.

As Chinese SOEs look increasingly to the US market, the US government will face a difficult balancing act between conflicting priorities. On the one hand, very real energy and broader national security concerns are at play—and these concerns have been the principal obstacles for Chinese SOEs seeking investments in the US in the past, as in CNOOC's failed 2005 effort to acquire Unocal. On the other hand, SOE investment into the US economy would bring much-needed new capital and job growth that would have appreciable positive economic—and political—ramifications across the US.

Two broad scenarios are possible. The US and China may find ways to effectively manage Chinese investment into the US. Beijing, for its part, must provide more transparency about the investment, funding, and even accounting practices of China's SOEs. This would help to assuage national security concerns in the US over Chinese investment. In Washington, policymakers must also work to complement the largely depoliticized CFIUS vetting mechanism with more public and high-level political support and perhaps even investment incentives for Chinese firms interested in the US market. The Obama administration will surely seek to provide some such support while China's Vice President Xi Jinping visits the US this week. Of course, coming to full agreement on these terms is impossible, but progress is certainly possible. Such progress would help to entrench bilateral investment as a tangible underpinning of a largely stable US-China relationship.

The other scenario is one in which the flow of Chinese SOE investments into the US remains largely stalled. This scenario would assuage US energy and national security concerns in the near-term. But it would actually aggravate national security concerns over the long run by setting up a structurally more conflicted US/China relationship.

In my view, that would be a mistake. Within its borders the US does and will maintain a position of strength in relation to China's SOEs. Given our robust IPR protection regime and our national-security investment review processes, we have sizable levers to encourage job-generating investment here while protecting our domestic security interests and protecting our own firms from unfair competition or intellectual property theft.

For years, US businesses have been willing to compromise their IPR protection concerns in China, understandably seduced by the promises and potential of the Chinese consumer market. The US government should likewise be able to capitalize on the promises of our own, much larger consumer market to shape the business practices of China's SOEs.

Thank you very much.

HEARING CO-CHAIR WESSEL: Thank you.

Mr. Saulski.

STATEMENT OF PAUL T. SAULSKI
ADJUNCT PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER
WASHINGTON, DC

MR. SAULSKI: Well, I'd like to thank the co-Chairs and the other distinguished members of the Commission and its staff for the opportunity to speak to you today. It's an honor to be invited.

As was mentioned in the introduction, in addition to being an adjunct professor at Georgetown Law Center, I hold the position of Senior Counsel at the Securities and Exchange Commission, but I'm appearing here in the capacity as a Georgetown law professor, and that my comments today are mine, mine alone, and don't represent the SEC, any individual commissioner, or the SEC staff.

Okay. So now with that aside, I've been asked to speak today on the competitive challenges posed by the Chinese state-owned enterprises. I will focus my remarks on the advantages that they have in their ability to raise capital at significantly cheaper costs than that are available to their foreign competitors.

This advantage has already been referenced this morning, and so I ask your pardon on the redundancy, but I hope my remarks may be able to draw some attention on how this process works and how this advantage comes about.

And also, as my co-panelists have mentioned, I would like to say that this advantage of low cost of capital does not exclusively come at the expense of foreign firms. Chinese private sector firms that compete with the state-owned enterprises are also often disadvantaged by the ability of the SOEs to raise capital at significantly cheaper costs.

The reason state-owned enterprises are able to obtain such cheap capital is a result of the condition of China's financial markets. Over the past two decades, China has made truly significant advances in transformation and development of its financial sector, yet, despite these impressive achievements, China's financial markets remain undeveloped and suffer from significant financial repression. Financial repression is described as an environment where financial markets are undeveloped and government intervenes in the credit allocation process.

In the case of China, financial repression is characterized by, among other features, the dominance or virtual monopoly in capital allocation by a select number of state-owned commercial banks; the government control over the interest rates, which results in low to negative real returns for deposit holders; a poorly developed debt and equity market; and strict capital controls.

These factors all create an environment whereby China's state-owned enterprises can obtain cheap capital which is funneled to them through the state-owned commercial banks. So a study of how this happens starts with the virtual monopoly of the credit allocation by China's four largest state-owned commercial banks: the Industrial and Commercial Bank of China; Bank of China; China Construction Bank; and the Agricultural Bank of China.

In 2009, these big four banks alone accounted for more than 70 percent of the assets held by the state-owned banking sector, which accounted to 43 percent of China's total financial assets. When we consider these figures, it's easy to see how these four state-owned commercial banks are the true gatekeepers of capital allocation in China and the overwhelming suppliers of capital to the state-owned sector, and, of course, this capital, again, is supplied to the SOEs at extremely low costs.

Loans to the state-owned enterprises are able to be provided by the state-owned commercial banks at such low costs due to the government's control over interest rates. China's central bank, the People's Bank of China, sets interest rates both for deposits and loans, both of which over the past several years have been kept at extremely low levels.

In fact, since 2003, the average real return on deposits has been negative once inflation is taken into account. Similarly, when adjusted for inflation, the real rate on bank lending has also been negative. As a result, the banks are able to provide their principal customers, the state-owned enterprises, with virtually free capital at the expense of deposit holders. I'll repeat that. The banks are able to provide their principal customers, the SOEs, with virtually free capital at the expense of their deposit holders.

And, in effect, this control over interest rates serves as a tool for China's industrial policy by channeling the implicit tax that's collected from Chinese households, due to the negative real return on their interest rates on their savings, through the state-owned commercial banks to selected investment projects and selected state-owned enterprises.

So this policy poses a competitive challenge to U.S. and other foreign firms as this negative real lending rate effectively acts as a subsidy to China's state-owned sector, and this is particularly evident in the capital intensive industries in which China's state-owned firms are competing globally.

One naturally asks why Chinese households would deposit their savings in banks if they are only going to lose their hard-earned money by doing so. The simple answer to this is there's no viable alternative other than the banking sector. This is a result of two more of the characteristics of financial repression in China that I mentioned earlier: the poorly developed debt and equity markets and strict capital controls.

A truly active bond market for individual investors has yet to develop in China, and despite all of the attention it's garnered over the past several years, China's stock market remains only a small player in the economy. It has no significant role in capital formation and is viewed as barely better than a casino to the average investor. Consequently, Chinese households do not see the stock market as a viable alternative to banks for their long-term savings.

Finally, as a result of the closed capital account, Chinese households are cut off from the ability to move their capital or their savings abroad to access any alternative offshore investment opportunities.

I would note that the one possible alternative to placing their savings in loss-generating bank accounts for the average Chinese household is to invest in residential real estate, which has led to a spectacular rise and, many believe, a bubble in Chinese housing.

So, in summation, China's state-owned enterprises benefit from a distinct competitive advantage by having access to extremely low cost of capital as a result of the repression of China's financial markets and control over interest rates.

I will end by pointing out that although these policies do significantly benefit state-owned enterprises and industries vis-a-vis their foreign competitors, these policies do not come without significant costs to the Chinese economy.

As I explained, the average Chinese household bears the brunt of financial repression and government control over interest rates through the loss of their savings. The result is a decline in the purchasing power of Chinese households, which limits their consumption spending. These policies also lead to an overinvestment in capital-intensive and export industries, and both of these factors significantly undermine the Chinese government's stated goal of transitioning from a growth path that relies on investment in export industries and one that relies on more domestic consumption.

And, finally, it has led Chinese households to place more of their savings into the housing market, which has resulted in a possible housing bubble that has significant potential for negative implications for China's future economic health.

Thank you, and I look forward to answering your questions.

PREPARED STATEMENT OF PAUL T. SAULSKI
ADJUNCT PROFESSOR, GEORGETOWN UNIVERSITY LAW CENTER
WASHINGTON, DC

Testimony before the U.S.-China Economic and Security Review Commission
February 15, 2012
Hearing on "Chinese State-Owned and State-Controlled Enterprises"
Panel II: The Competitive Challenges Posed by Chinese State Owned Enterprises

Paul Saulski
Adjunct Professor
Georgetown University Law Center

I would like to thank the co-chairs and the other distinguished members of the Commission and its staff for the opportunity to speak to you today. It is an honor to be invited.

First, as is indicated in my biographical information, in addition to serving as an adjunct professor at the Georgetown University Law Center, where I teach courses on international securities regulation and China's financial markets, I hold the position of senior counsel in the Securities and Exchange Commission's Office of International Affairs. Before I begin my prepared remarks, I would like to emphasize that I am appearing here in my capacity as a Georgetown Law professor and that my comments today are mine and mine alone, and do not represent the views of the SEC, any individual SEC Commissioner or of the SEC staff.

I have been asked to speak on the topic of the competitive challenges posed by China's state-owned enterprises. I will focus my remarks on the advantage—some would argue unfair advantage—that China's state-owned enterprises have in the ability to raise capital at costs cheaper than that available to their foreign competitors. I would note, however, that this advantage in a low cost of capital does not exclusively come at the expense of foreign firms. The Chinese private sector competitors to these state-own enterprises are also often disadvantaged by the ability of state-owned enterprises to raise capital at significantly cheaper costs. The reason state-owned enterprises are able to obtain such cheap capital is result of the structure of China's financial markets.

China's Repressed Financial System

Over the past two decades, China has made truly significant advances in the transformation and development of its financial sector, a transformation that has witnessed the establishment of the Shanghai and Shenzhen stock exchanges, the restructuring and public listing of China's largest banks and the creation of a nascent corporate bond market. Also, China has adopted much of the institutional architecture required for well-functioning financial markets and market-based capital allocation—for example, the enactment of laws and regulations governing financial intermediaries, the adoption of international accounting standards, and the creation of ostensibly independent market regulators, to just name a few. Despite these impressive achievements and important steps, however, China's financial markets suffer from significant financial repression. Financial repression describes an environment where financial markets remain undeveloped and government intervenes in the credit allocation process. In the case of China, financial repression is characterized by among other features:

- The virtual monopoly in capital allocation by a select number of state-owned commercial banks;
- Government control of interest rates that result in low to negative real rates of returns for deposit holders;
- Poorly developed debt and equity markets; and
- Strict capital controls.

Dominance of the Big Four Sate Banks in the Financial System

A study of how state-owned enterprises are able to obtain cheap capital begins with the fact that China's credit allocation system is dominated by the four largest state-owned commercial banks: Industrial and Commercial Bank of China (ICBC); Bank of China (BOC), China Construction Bank (CCB) and Agricultural Bank of China (ABC). In 2009, the big four banks alone accounted for more than 70 percent of the assets held by the state-controlled banking sector, which was 43 percent of China's total financial assets. When considering these figures, it is easy to see how these four state-owned banks are the true gatekeepers of the capital allocation in China and the overwhelming suppliers of capital to the state-owned sector. Also, despite recent figures that suggest that credit has become increasingly available to private sector firms as a result of the 2009-2010 stimulus-package-driven credit boom, the vast majority of the credit financed by the big four banks is sill directed to state-owned enterprises and at extremely low costs.

Government Controlled Deposit and Loan Interest Rates

Loans to state-owned enterprises are provided by the state-owned commercial banks at such low costs due to the government's control over interest rates. China's central bank, the Peoples Bank of China (PBC), sets interest rates for both deposits and loans, which for the past several years have been kept at very low levels. In fact, since 2003, the average real return on deposits has been negative once inflation is taken into account. Similarly, when adjusted for inflation, the real rate on bank lending has also often been negative. The spread between these two rates allows the banks to remain profitable despite the low lending rates. Simply, the banks are providing their principal customers—the state-owned enterprises—with virtually free capital at the expense of deposit holders.

The low interest rate policy serves as a tool for China's industrial policy, channeling the implicit tax collected from Chinese households through this negative return on their savings via the state-owned banks to selected investment projects and industries. Chinese government control over interest rates poses a competitive challenge to U.S. and other foreign firms as the negative real lending rates act as a subsidy to China's state-owned sector. This is particularly evident in the capital-intensive industries in which China's state–owned firms are competing globally.

Lack of Alternative Options for Account Holders

One naturally asks why Chinese households would deposit their saving in banks if they are only going to lose their hard-earned money by doing so. The simple answer is that there is no viable alternative to the banking sector. This is the result of two additional characteristics of financial repression mentioned earlier: poorly developed debt and equity markets; and strict capital controls. A truly active bond market for retail investors has yet to develop in China and, despite all of the attention they have garnered over the past several years, the Shanghai and Shenzhen stock markets remain only small players in China's economy and have no significant role in capital formation. The stock markets are extremely volatile and have witnessed rapid increases in share values that are followed by precipitous price drops and then long periods of stagnation. In addition, there is a perception that insider trading, stock manipulation and reporting fraud are endemic in these markets. As such, the stock markets are viewed as barely better than a casino by the average investor. Consequently, Chinese households do not see the stock market as a viable alternative to banks for long-term savings.

Finally, because of the closed capital account, average Chinese households are unable to move their money abroad to access alternative offshore investment opportunities. I would note that the one possible alternative to placing their savings in loss-generating bank accounts for the average investor is to invest in residential real estate, which has led to the spectacular rise—many believe bubble—in Chinese housing.

The Impact of Financial Repression and Controlled Interest Rates

In summation, China's state-owned enterprises benefit from a distinct competitive advantage, having access to extremely low costs of capital as a result of the repression of China's financial markets and government control over interest rates. I will end by pointing out that, although these policies do benefit state-owned enterprises and industries vis-à-vis their foreign competitors, these policies do not come without significant cost to the Chinese economy. As I explained, the average Chinese household bears the brunt of financial repression and government controlled interest rates in the form of lost savings. The Result is a decline in purchasing power of Chinese households, which limits consumption spending. These policies also lead to the over investment in capital-intensive and export industries. Both of these factors significantly undermine the Chinese government's stated goal of transitioning to a growth path that relies less on investment and net exports and more on domestic consumption. Finally, it has led Chinese households to place more of their savings into the housing market, which has resulted in a potential housing bubble that has the potential for negative implications for China's future economic health.

Thank you and I look forward to answering any questions you may have.

Panel II – Questions and Answers

HEARING CO-CHAIR WESSEL: Thank you. And you didn't have to read so quickly, but thank you.

MR. SAULSKI: Sorry.

HEARING CO-CHAIR WESSEL: No, no. I'm saying thank you because you were right within the time. So appreciate it, and if you can try and keep answers short so we can get to hopefully more than one round of questions.

Let me ask you, if I could, Mr. Saulski, understanding this is only in a theoretical academic sense that I am asking this question, how can we look at the Securities and Exchange Act and its ancillary laws, regulations, et cetera, and the materiality concept as it relates to Chinese SOEs that are listed either on U.S. exchanges, New York Stock Exchange, or others, or where there may be derivative investments, ADRs, et cetera, or Fidelity or somebody else investing in some kind of activities or private equity?

In looking at the reports of some of these entities in terms of their listings on New York exchanges, I see some different qualitative differences in terms of the transparency of their reporting.

For example, Mr. Brightbill is involved in a big solar case. If those subsidies are, in fact, found not only actionable, but are sanctioned by the U.S. government, that could have a material effect on those companies' activities and the rate of return to their investors, materiality being a function of net income in terms of those companies.

Shouldn't that be listed potentially, again, in an academic sense, as in the annual report's risk profile, you know? And Commissioner Bartholomew and I both serve on public companies. The up-front risk profile in the annual reports is rather broad on anything that might happen, you know, the risk of a tsunami, et cetera.

From an academic sense, how do you view the reports of the Chinese entities listed on our exchanges? Do they provide the same level of transparency that a U.S. or other foreign entity uses in terms of their annual reports?

MR. SAULSKI: Well, purely from an academic point of view, and excuse me for speaking very quickly earlier. I--

HEARING CO-CHAIR WESSEL: No, no. Please, getting through issues is great.

MR. SAULSKI: --am often accused of that. HEARING CO-CHAIR WESSEL: Thank you.

MR. SAULSKI: Well, first, it's interesting. When often we are discussing the Chinese companies listed in the U.S. and the amount of disclosure they have and any problems with reporting, the attention is often focused not on the state-owned enterprises or even Chinese companies that are specifically listed as Chinese companies.

When we look at how many, quote-unquote, Chinese companies are listed in the U.S., if you were to look at the SEC's Web site for foreign private issuers, there are only 11 Chinese companies listed there. The vast majority of companies and the majority of companies that kind of draw people's attention to are actually incorporated offshore, set up as foreign enterprises in China and then listed from shell companies usually in Cayman Islands or the BVI.

And that's a whole another issue to this one about state-owned enterprises, again, which are only 11, and the interesting--I could almost turn around the question, that perhaps if we were to force or would require these companies to emphasize these subsidies and benefits they get from the Chinese government, that may actually encourage investors to think that these are really good investment opportunities.

HEARING CO-CHAIR WESSEL: Okay.

MR. SAULSKI: Though the idea of, I believe, without having spent too much time looking through their prospectuses, I believe they probably do cover their bases quite well under political risks, which I believe this idea of material effect of any sanctions being taken against them due to trade violations, et cetera, though it's something that probably needs to be looked into deeper.

HEARING CO-CHAIR WESSEL: And from cooperative ventures, looking at GAAP, IFRS, the PCAOB or other activities, and I believe that there were some aborted discussions between the U.S. and China on PCAOB, I believe it was last year, what kind of dialogue is there going on, again, academically only, in terms of compatibility of the Chinese and the U.S. system or the Western system in terms of disclosure and transparency?

MR. SAULSKI: Well, you're putting me in a very difficult position by trying to speak academically about something that I'm engaged in at the SEC, and so I'm going to have to step lightly given that I'm not here in my capacity as a SEC staff.

But, obviously, those companies that are listed here, it's not a question of--and who are reporting to the U.S.--it's not a question about convergence to some sort of norm. It's they are required to meet the requirements of any foreign private issuer or any U.S.--or if they're listed as a U.S. company, any U.S. issuer, as any others, and so there is a dialogue with the SEC, and this has been reported in the newspapers so I can speak freely on this, about working with the regulators on how to obtain information so as to better facilitate determining whether that disclosure has been done appropriately.

HEARING CO-CHAIR WESSEL: Understand. Okay. My time has expired.

Mr. Fiedler.

COMMISSIONER FIEDLER: A non-academic question. Why should we let them into the United States and do business? You just got done describing a predatory sort of apparatus. So U.S. economy is a chicken coop, got a bunch of chickens in there, and we're saying we got a fox. And, oh, wants to eat a couple of chickens. Well, let him in. We wouldn't do that.

Why--we were complaining when the U.S. government momentarily intervened in bailing out General Motors, but we seem to have no problem letting state-owned companies from any country that may enjoy the benefits that you describe from entering the United States. Why should we? Because we have some mistaken belief of reciprocity or we think that that's going to knock down the walls of our free trade and free flow of investment to the detriment of American people on a daily basis.

I'm aghast at the fact that reciprocity when dealing with state-owned enterprises in a policy sense in the United States is not discussed. We wouldn't let them buy Unocal, but some people wanted to, but we cannot buy a Chinese oil company. I'm miffed about this. I don't understand it.

MR. BRIGHTBILL: Yes, just to start, you make some very good points, and there's no reciprocity here, and my understanding is there are more than 100 sectors in manufacturing and services in China where our investment is off limits, including the steel industry and many others.

Now, I mean certainly there are benefits to investment here in the United States if it's done on a commercial and a transparent basis.

COMMISSIONER FIEDLER: Let me stop you a second.

MR. BRIGHTBILL: Yes.

COMMISSIONER FIEDLER: The issue becomes more fundamental here.

MR. BRIGHTBILL: Yes.

COMMISSIONER FIEDLER: You still have a state enterprise. The Chinese have a perfect right, it seems to me, to create state-owned enterprises. We, on the other hand, have a perfect right to say we don't believe in state-owned enterprises. We don't allow them in our country, and therefore we're not going to let them in here, whether they have--is it all about they carry greenbacks, and we are covetous of greenbacks?

MR. BRIGHTBILL: Again, I don't think it's only the trade deficit and where we stand, but it's also the United States can potentially benefit from foreign investment in terms of jobs and manufacturing and so forth.

But, again, I share your concerns about state-owned enterprises coming here where we have no transparency about what is involved, whether or not the initial investment is made on a commercial basis, or whether a state-owned enterprise would operate on a commercial basis once it comes here.

COMMISSIONER FIEDLER: So you're defining commercial basis, I trust, as having no cost of capital?

MR. BRIGHTBILL: Exactly. I mean there has to be a cost of capital so that is not on a commercial basis. You're right.

COMMISSIONER FIEDLER: So what you're saying is if they're a state enterprise that wants to buy an auto parts company or a solar company in the United States, and they had no cost of capital, we would not let them purchase?

MR. BRIGHTBILL: Well, that would not be on a commercial basis.

COMMISSIONER FIEDLER: Okay. I'm just--

MR. BRIGHTBILL: If there's no cost of capital.

COMMISSIONER FIEDLER: You were talking euphemistically before.

MR. BRIGHTBILL: That's right. That is considered a subsidy under the trade laws.

COMMISSIONER FIEDLER: That is not true today; is it?

MR. BRIGHTBILL: Well, in the area of--

COMMISSIONER FIEDLER: No, no, in the United States.

MR. BRIGHTBILL: No, in the area of goods, it's not. And in investment--

COMMISSIONER FIEDLER: We'll let them in if they have no cost of capital today.

MR. BRIGHTBILL: Defer to my colleagues, but there are no tools to deal with that situation necessarily other than under the CFIUS for security.

DR. GORDON: CFIUS isn't about that.

COMMISSIONER FIEDLER: CFIUS is largely a national security issue.

MR. BRIGHTBILL: Exactly.

COMMISSIONER FIEDLER: It is not a national economic security.

MR. BRIGHTBILL: That's right.

DR. GORDON: So the dilemma here is the United States is, the United States is interested in/committed to an open investment environment at home, both for generating employment, also for facilitating our ability to create an open investment regime more broadly in the world.

These are huge tradeoffs that we're talking about here. The dilemma is that we have a mechanism in place to discuss the national security element of this, but we do not have a mechanism in place to address the sort of level playing field on financing that you're talking about.

COMMISSIONER FIEDLER: Yeah. Our time is up so I want to make one just final statement here. Is what you're--I want to sum up what you're saying, is that we do not currently have a regulatory regime in the United States that fits today's world?

DR. GORDON: I agree with that statement.

MR. SAULSKI: Can I jump in there?

HEARING CO-CHAIR WESSEL: Quickly you can, yes.

MR. SAULSKI: Well, when we talk about access to letting these companies into the U.S., I think there's two different types of entering our markets. There is, of course, direct investment, which I think my colleagues have been discussing right here.

COMMISSIONER FIEDLER: Capital markets.

MR. SAULSKI: And then there is the capital markets portfolio investment. And I think, in that case, it is probably to our advantage that we, in fact, do allow them to access our capital markets.

Why do I say that? Because capital, with today's global environment, global capital markets where money can cross borders at the speed of light at the click of a button, investors are not bound by borders. Our investors, U.S. capital institutional investors, will invest in those companies wherever they go, wherever they're listed, whether they're in Hong Kong, whether in Singapore or London.

So by having them come to the U.S., they are binding themselves to our regulatory regime, which we can at least guarantee is going to be more stringent and better and policed better possibly than those overseas.

COMMISSIONER FIEDLER: But maybe not sufficiently stringent?

MR. SAULSKI: We can discuss whether we need to heighten our oversight.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR WESSEL: Co-Chairman Cleveland.

HEARING CO-CHAIR CLEVELAND: Mr. Saulski, we had a witness from the SEC, I think last year. We talked about this very issue and talked about the filings that SOEs go through, and as you point out, they're identical to what American companies are required to submit, which in and of itself begged the question of is that adequate? If you organized very differently, is it adequate?

So I'm hoping that the SEC is continuing to pursue the question of the adequacy of the content of material risk when it comes to Chinese companies with a view that it is challenging to follow up inside China once there is a real problem of risk.

Before I go further, Commissioner Reinsch asked me to submit for the record a report by the Brattle Group, which I think we have a copy of to give the recorder, which I think offers an alternative view to some of what Mr. Brightbill has been discussing.

I'm doing it on behalf of Commissioner Reinsch, and thus ends my responsibility.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Dr. Gordon, I am really interested in the point that you just made, that the CFIUS process serves a specific purpose when it comes to national security, and that there is not an adequate mechanism to address some of the changes in the global market place, particularly when it comes to China, and I would suggest maybe Russia is in this category as well.

So given your vast experience, of which I am personally very knowledgeable, in the interagency process and how government works, what's your plan? What would your proposal be if you were in a position to advise either the Congress or the administration on some kind of parallel mechanism to CFIUS? Or would it be a CFIUS subcommittee that dealt specifically with economic security issues? What would you suggest might actually work given the ossified nature often of the interagency process?

DR. GORDON: Yes. So my view--

HEARING CO-CHAIR CLEVELAND: I want all of your contributions.

DR. GORDON: My view here is that this should not be combined with CFIUS because I think that the CFIUS process is rightly focused on the national security dimension, and it demands a much lower level of expertise and knowledge on financial investment issues, et cetera.

So what we need, what we need more broadly is some kind of a parallel, and I don't have a specific element plan in mind, but I do think that we need a complement to CFIUS on the more financial and regulatory side that has to do with enabling a much greater kind of insight into the operations of these firms.

I think that the goal here will be to create for foreign direct investment the kinds of incentives that I think potentially could be created for portfolio investment, but I think right now that not only do we not have this, but there's a real lacuna within the U.S. government in terms of who's going to even look at this.

So not only are we challenged in a regulatory sense, which is I think the ultimate target here, but who's really tasked in the USG to get their arms around the kinds of questions that you would want to address in an appropriate regulatory framework?

Is it the Treasury Department? Is it the Commerce Department? Is it the State Department? And I think the first step here is to create and build some expertise and focus on the executive side on these issues as part of a pathway forward to getting an appropriate regulatory framework because right now frankly we are not positioned to even begin this effort.

MR. BRIGHTBILL: Just a couple of thoughts in response. The United States should consider some form of heightened review of incoming investment by state-owned and state-controlled enterprises. Many other countries have this kind of a review process. Canada applies an economic benefit test.

There are OECD guidelines for ensuring that state-owned enterprises are abiding by an established set of rules.

HEARING CO-CHAIR CLEVELAND: Can I interrupt you on this point?

MR. BRIGHTBILL: Yes.

HEARING CO-CHAIR CLEVELAND: Guidelines are different than mechanisms. How do you see in terms of a process complementing what Dr. Gordon said? What would be behind? What would be the enforcement structure of those kind of guidelines or the suggestions you just raised?

MR. BRIGHTBILL: Well, I'm not sure I have the exact mechanism as much as the elements I'd like to include, but I do think a CFIUS-like process with a different agency, apart from CFIUS, to review the competitive neutrality of these enterprises when they invest here, to obtain information before any investment occurs, is something that should be explored.

We're also laying the groundwork for this in the Trans-Pacific Partnership negotiations, which I can talk some more about, but basically we're laying out this principle that investment in operations has to be on a commercial basis. There has to be transparency so that there's an ability of one TPP member, the United States, to ask other TPP countries when a state-owned investment is headed toward the United States.

HEARING CO-CHAIR CLEVELAND: Thank you.

Mr. Saulski, do you have--

MR. SAULSKI: I'll defer to my colleagues since I'm going to focus on financial investments.

HEARING CO-CHAIR WESSEL: Before I turn to Commissioner Slane, let me just ask the witnesses if they could look at both the Canadian and the Australian mechanisms. They are, in fact, beyond just indices. They are, in fact, mechanisms to review inward-bound investment. We'd love to get your opinions of those to the extent you have one, and whether that should be any kind of guide to our activities.

Commissioner Slane.

COMMISSIONER SLANE: Thank you for your testimony. It's really helpful.

Following up with Commissioner Fiedler's statements, I believe that the state-owned enterprises are coming, and we want their jobs, but not at the cost of destroying our industries, and how an American company can compete with a Chinese solar manufacturer or a Chinese steel company is beyond me.

I mean my question is what do we recommend to Congress? Do we recommend the implementation of the Canadian test? How do we solve the problem of getting them into our economy and trying to compete when they have no cost of capital and all these other subsidies we've talked about?

DR. GORDON: So let me make a couple of points here, and I think the first point is that we need to come at this through two lines of attack. One is regulatory framework at home and the second is an institutional process abroad, and I completely agree with Timothy Brightbill that TPP is an extraordinary, potentially important pathway forward on the latter.

We're frankly behind the curve on the former, and I think the former, we still have very considerable assets, that the U.S. market remains extraordinarily attractive. It's extremely attractive to Chinese firms. They want in. The Chinese government is very sensitive here.

So I think the notion that is sometimes cast about that the United States doesn't have leverage here, I don't buy, but I think the thing is how do we build up to create a regulatory framework, and on what basis of expertise and assessment, and who does this to move this forward?

And, again, I don't have a laid out plan here. I know that, I mean these are issues I've followed, both the Canadian and especially the Australian mechanisms here, and--

COMMISSIONER SLANE: Yeah. If I can interrupt you. Let me just--Anshan Steel wants to come into Ohio, open up a steel mill to employ 2,000 workers, another 8,000 in the supply chain. The governor of Ohio wants this, but they will destroy the U.S. steel industry. What do we do? That's the dilemma. Do we let Anshan Steel come in or not?

MR. BRIGHTBILL: Commissioner, I can speak a little bit to the Anshan situation. That is something that I have some familiarity with, and it's difficult because we don't, we don't have all the tools we need to review that kind of investment, to have any idea of whether it would be done on a commercial basis or not. So instead we have to try and--

COMMISSIONER SLANE: We know it's not going to be done on a commercial basis. I mean we're just kidding ourselves.

MR. BRIGHTBILL: So the industry, both many of the steel companies, as well as the steelworkers, raised serious concerns about this, tried to make lawmakers aware about the concerns to ensure that this wasn't going to happen in a damaging way.

But that's just the beginning of potential investment. Most of China SOE investment here has been in financial forms, not--much less in manufacturing and mining and raw materials and so forth. So that is a very serious challenge yet to come.

I also wanted to highlight countries that have screening mechanisms, we have a list of about a dozen different countries that have investment review frameworks, and it won't surprise you at all to know that China has a very sophisticated investment screening mechanism.

First of all, there are a hundred industries that don't allow foreign investment at all, but China also has set up specific foreign investment regulations that introduce a national economic security screening requirement, but also an economic screening requirement if there is influence on Chinese economic security.

So, again, going to the question of reciprocity, we need to have some tools here, but we have some tools with respect to goods in terms of the trade remedy laws although there is such a lack of transparency, it's difficult to apply those rules, for example, at the World Trade Organization.

In the area of services, in the area of investment, we have even less to go on to know what the nature of the SOE is or what the nature of the investment is. It's extremely difficult.

HEARING CO-CHAIR WESSEL: Mr. Brightbill, if you could supply that list, and if you also have any of the background information, to our staff, I think it would be very helpful for us to look broadly at that issue.

MR. BRIGHTBILL: We'll certainly do that.

HEARING CO-CHAIR WESSEL: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you all very much for your great testimony.

Commissioner Cleveland pointed out a very interesting study, quoted also by Under Secretary Hormats, about just how unproductive state-owned enterprises are, and I think Mr. Saulski was commenting on that as well, and it basically said that productivity decreases with every step away from private to state-owned, and so on and so forth.

So, essentially, what I read from that is there's incredible amount of waste and inefficiency in the Chinese economy right now. So I would change the question and say why not welcome all the Chinese capital in the world into the United States? They're going to waste their money in China. They're going to waste their money in Africa. Why not waste their money here?

And the example of Anshan Steel, if they're going to come into Ohio and create 2,000 jobs, and probably overpay for what they're getting, why wouldn't we welcome this?

MR. BRIGHTBILL: Just to start, Commissioner, the problem, I think, is one of market distortion. If Anshan is to come here, even to create jobs, what is going to happen to the price of steel as a result is there going to be distortion because that company is not operated on a commercial basis but on a basis that's favorable to the Chinese government.

The same thing in the solar industry. I mean we want to have U.S. manufacturing here that thrives for the long term. It's a very innovative industry. These solar cells and panels are improving every year.

COMMISSIONER BLUMENTHAL: Could I ask a question about that?

MR. BRIGHTBILL: Yes.

COMMISSIONER BLUMENTHAL: So, we wanted an auto industry as well, and lo and behold, the Japanese and the Koreans have created a U.S. auto industry. They're essentially North American companies that are employing North Americans, in the South mostly, and I would imagine in the Japanese and Korean case, they're more efficient.

In the Chinese case, they'll be less efficient; they'll overpay as they do everywhere else, as they do in their own economy. Again, I'm not sure what, I'm not exactly sure what the problem is.

The market distortion, it seems to me, is more in the case of China making bad investments. I wonder if I could get someone else's response to that.

DR. GORDON: So I mean I do believe that, as I suggested in my testimony, that the Japanese model in some ways is what we should be aspiring towards, but remembering that the Japanese firms involved were commercial enterprises, and so I think--

COMMISSIONER BLUMENTHAL: But they were commercial enterprises with a great deal, at first, at least, of many--

DR. GORDON: Of some subsidy attached. So I do think that we do want to have an open investment climate.

On the other hand, I think that to deny the competitive challenge is a problem, and that's where we--the challenge on where we are, Dan, is that we can't do--we don't have the mechanism to do an assessment of potential costs and benefits here on this.

And I think that's what we need is a mechanism to be able to do that. I'm with you that the assumption here should be favorable to our concept of an open investment climate, that that's important to the United States. It's important for U.S. competitiveness, but it can't be--that commitment to openness can't be at the expense of all of these other factors, and right now I think we're heading in--I agree with the people who said we're seeing the tip of the iceberg, and that this is going to be a challenge.

COMMISSIONER BLUMENTHAL: Let me ask another question here, and that is so China has thrown a lot of money into solar, you know. I don't know if that's actually gone to market or not.

We now have a natural gas revolution in the United States, and all of a sudden China, because of market forces, because of development and because of shale technology and all the rest of it, now, China is interested in natural gas, and they're invested in--they've made some plays here in the United States in natural gas. Is that in any way harming us--the fact that they invested in natural gas?

DR. GORDON: Not to my mind.

MR. BRIGHTBILL: Just to address the harm and the distortion in the solar industry, in particular, it is primarily investment in subsidies that the Chinese government has made in China to manufacturing. It's not investment here yet.

COMMISSIONER BLUMENTHAL: So what if they're subsidizing and therefore inefficiently overpaying for--because of the subsidies--plays in natural gas in Chesapeake and Devon, yet we're getting the capital that isn't coming to them, isn't coming to those companies otherwise?

MR. BRIGHTBILL: Again, I think the problem is what happens when they're distorting the market. In the meantime, what happens to companies that are operating on a commercial basis and that wouldn't be there for the long term because of the distortive effects of the Chinese companies operating either in their own country or here in the United States? I think that's the fundamental problem.

DR. GORDON: And they don't have the opportunity in natural gas to develop oligopolistic or market shaping power. In some of the sectors, I think that's the concern, is, on the one hand, the cost of capital. On the other hand, it's ability to basically reshape markets so that barriers to entry by other players, other countries' players, really disappear, but the dilemmas that we're talking about right now are what we need to have mechanisms to more systemically assess.

COMMISSIONER BLUMENTHAL: Thank you.

MR. SAULSKI: I know the Commissioner's time is up, but just really quickly, and I want to, if you don't mind, taking your question from another angle, is I think it's really important that we do not lose track of this idea that these assets and this capital is being supplied to these Chinese SOEs so unproductively, and that this is actually a significant drag in the long-term viability of their own system and their own economy.

COMMISSIONER BLUMENTHAL: Right.

MR. SAULSKI: And why I take issue or I disagree, to some extent, with the previous panels and their quite sanguine view about the viability of China's financial model, and I think we will be seeing if they continue this, to use their financial markets in this way, to have some significant repercussions and significant drag on their economy, which may actually have--may answer much of your problems or questions that you have before in and of itself.

COMMISSIONER BLUMENTHAL: Thank you.

HEARING CO-CHAIR WESSEL: I'm reminded of the last panelist saying that they're shooting themselves in the foot. As I said to a previous panel a couple of hearings ago, the problem is their foot may be on our chest. So got to worry about that.

Commissioner Wortzel.

COMMISSIONER WORTZEL: As a group, you've gone back and forth mentioning cost of capital in other countries and state-owned enterprises. So what is it that bothers you about the behavior of Chinese state-owned enterprises and the Chinese government that does not similarly concern you about Finnish or Swedish or Singaporean state-owned enterprises?

Is it the nature of the government? Is it the scope and predatory scale that comes with that scope? But I'd like to have you define that because I can tell you that if you're a free trader, you're going to say, well, you know, what's the difference? State-owned is state-owned.

So what is it about China, in your mind, that makes it different? And second, with respect to the long-term, if the Chinese Communist Party's main focus is to maintain itself in power and to control the country, why would it ever modify the model it has since if it privatizes, it loses control?

DR. GORDON: So I think the challenges here are two. I think one of the challenges here, as is the case with a lot of issues in China, is the scale challenge. I mean intellectual property has always been an issue in emerging markets and developing countries. The problem in China is that China on virtually every measure, it's the key driver of increments of change in the whole world, and so you have a huge scale issue here.

I think secondly is that the Chinese do have a strategy of going outward, and that that strategy is assertive, more significantly now, and I think what's going on now is a cross pressure. I think a lot of what's happening now in China is this quest for national championhood is being driven by the enterprises themselves, that is it's enterprises making an argument about their national economic significance in order to give these firms access to these resources that then give them an enormous competitive advantage on the global stage.

So, in some ways, it is the marriage between this state-owned enterprise system and this larger economic model that has generated these enormous financial reserves that can then be tapped, and it's this circle, and that's what I was trying to emphasize in my testimony, that I think this is pretty new, and I think it's a big challenge.

MR. SAULSKI: If you don't mind, I'll try to answer your second question, which is why if this system is working so well for them in maintaining their power, and that's all they really care about, would they ever change.

And I think the answer would be that, as I alluded to in my previous question or answer, is that this model I don't believe is sustainable in the long or even middle term, and that significant changes are going to be needed to be done if the Party/if the government wants to maintain providing this continued economic growth and giving what the people are expecting.

The real problem for them, though, is they're currently in a situation where the system has worked for them very well up to this point, and it's also providing them with a lot of benefits. And you compare that to economists, people like me, and even their own premier saying this is unsustainable, it needs to be adjusted, we need to do something about it, but that's down the road.

And they face entrenched interests, which include the state-owned enterprises, the export sector, the local governments, administrative commerce, and so it's going to be very difficult for them to do that, and, in essence, rather than Adam Smith or--you've got Mancur Olson in play in China, and it's going to be very difficult for them.

MR. BRIGHTBILL: Just very briefly, in response to your first question about why is China different from other SOEs, I think three or four elements.

First is just the absolute lack of transparency and what's going on with these state-owned enterprises versus other ones, and similarly, the absolute lack of openness in China compared to SOEs located in other countries.

Secondly, I think, is the operation not on market principles, but for other country objectives: to obtain intellectual property; to obtain access to raw materials; to start joint ventures in China where then the technology is taken away, you know, motivations other than market motivations; and last is just sort of the systemic violation of trade rules that happens with China and its SOEs. They don't notify their subsidies to the WTO; they provide export subsidies that are illegal. Those are kind of the pervasive things that make the Chinese SOEs different from others, in my view.

HEARING CO-CHAIR WESSEL: Commissioner, Chairman Shea.

CHAIRMAN SHEA: Mr. Saulski, I thought your testimony on financial repression was extremely valuable. It was short, it was written in English, and it just was a nice summary of the problem.

So I just want to sort of ask a question that I think is a corollary of Commissioner Wortzel's question. Is it not in the United States' interest for China to lift its financial repression policies, the collective group of policies that financially repress Chinese households, stimulate more domestic consumption in China, and resolve these global imbalances? Isn't that in the United States' strong interest?

MR. SAULSKI: Well, the very short answer to go with my short statement is, yes, it is definitely in the U.S.' interests and--

CHAIRMAN SHEA: Very strong interests.

MR. SAULSKI: Very strong interests. That is why, and within this package is not only trying to get China to shift from this control over the interest rate policy, but also obviously this ties hand-in-hand with their undervalue of the renminbi and the exchange rate.

CHAIRMAN SHEA: Right.

MR. SAULSKI: As well as opening up their capital account.

CHAIRMAN SHEA: Right. It's a panoply of policies--

MR. SAULSKI: Exactly.

CHAIRMAN SHEA: --that repress Chinese households. But the main impediment to changing this is the SOEs; right? The political power of the SOEs?

MR. SAULSKI: I don't believe that that's the main impediment. I think, as I mentioned earlier, I think there's a significant--there's an impediment there because of the entrenched interests of the SOEs that's going to be hard for them to make changes on certain of these aspects, particularly the exchange rate and the interest rate controls, though they probably would be much more open to capital account liberalization and other aspects of improving their financial system that would benefit them.

The largest impediment is the fact that actually this is an extremely complex and very difficult maneuver for the Chinese to make, to move from this investment-led, intensive kind of financial-repression-led investment growth model to shifting over to a more market-driven consumption-led model. It's actually very difficult. They have to make a lot of serious significant changes including--

CHAIRMAN SHEA: Political changes.

MR. SAULSKI: --political but economic changes--freeing up the exchange rate, reworking their monetary policy system, improving regulation and supervision of their financial system now that the government is not just going to be telling them loan at this much, pay depositors this much. There's going to be much more need for significant infrastructure on regulation, and they need to develop their financial markets, their debt, their equity markets.

All these need to be done, and it has to be done in a certain sequence so that they don't create capital flight and a financial crisis. So not to diminish the fact that these, again, as I mentioned earlier, there are political impediments because of the entrenched interests, and, as you mentioned in your earlier question in the previous panel, the notion that there is now becoming kind of an entrenched interest that almost has family-led connections, it is actually more than just they don't want to do it because it's good for them. It's difficult, there's a long sequence of financial and economic changes that need to occur.

CHAIRMAN SHEA: Maybe I'll direct my next question to Dr. Gordon, since I know you want to jump in, since this is a panel on SOEs, what can the United States--and since removing these policies that financially repress consumption by Chinese households is in the United States' strong interests--

DR. GORDON: Yes.

CHAIRMAN SHEA: --what should the United States be doing other than jawboning, or is jawboning the only thing we can do?

DR. GORDON: So I think, I mean my view is that the danger--the Chinese know what they have to do, and they would like to do it, but they cannot do it because it is so threatening to them politically. I mean the most important thing to realize about the Chinese is that they consider themselves on this very, very fragile pathway, and that I think for most outsiders looking at a country that has double-digit growth for decades, you know, taking hundreds of millions of people out of poverty, you would think that the government is optimistic. They're not. They're very pessimistic.

I think, again, I think the most important thing that we can do to help this process is to work towards regional arrangements that put the question of open investment environments front and center in these agreements. We can move forward in those. Those will put a lot of pressure on China. I think that we can focus more on the costs of these arrangements, not to U.S. businesses, but to Chinese consumers, Chinese small and medium businesses, and we can begin to create a mechanism here that will enable us to have some degree of influence on investment influences and use that in a positive direction as well.

CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Senator.

COMMISSIONER GOODWIN: Thank you, Mr. Chairman.

I'd like to return to this notion of reciprocity and a level playing field and pose a question to Dr. Gordon based upon some of what you read in your prepared remarks regarding the biggest challenge is in the Chinese market itself, particularly the challenges posed by state-imposed barrier to entry, and ask this question.

I'd like to probably inject a little bit of levity into the proceedings and talk about a matter not of particular national and strategic importance but one certainly paramount to my own mental well-being, and that is professional basketball.

There was an article in The New York Times last week about the National Basketball Association's recent efforts, unsuccessfully, to expand their sizable presence in China, up to and including the development of an NBA owned and operated professional basketball league.

Yet, despite the NBA's global brand and preeminence and indeed its already sizable popularity and presence in China, the article suggests that the leaders of the NBA misjudged the Chinese political landscape, particularly, and perhaps especially, this state capitalist system that they have where members of the pro league itself, its TV partners, and the member teams were all, at least partially, state owned and operated.

If you're familiar with that article, I'd certainly appreciate your insight, but more broadly talk a little bit about these state-imposed barriers to entry in the Chinese market itself and what U.S. policymakers can do?

DR. GORDON: We do not have a lot of direct leverage in China. When I look at U.S. firms, and we have--a lot of American firms who invest in China are our clients, and I'm not going to give away any proprietary information here--but I think the striking thing to me is that U.S. firms didn't go into China with rosy-eyed views. They did pretty serious assessments generally.

But almost all of them made the same analytic mistake of very, very dramatically misunderstanding the speed by which Chinese competitors would be able to emerge, and firms that thought it was going to take 20 years, it happened in six or eight. Firms that thought it would take ten years, it happens in three or four.

That, the emergence of these Chinese competitors, speaks to the nature, the difference in the nature of Chinese SOEs and Chinese state capitalism versus all of the other cases here that we're talking about.

I think it's that pervasive notion of we're going to get these foreign corporations in, we're going to benefit from that inflow, and then just as fast as we can, we are going to enable the development of competitors to those firms. I think that that's the essence of the challenge in China.

Now, I think the only way to address this actually is through what we're doing regionally, what we're doing here in our country, and to hope that the dynamics of this change inside of China, because there is a lot of growing opposition to the monopolistic benefits that these national champions are garnering. We really do not have a lot of leverage in a short-term way over this.

COMMISSIONER GOODWIN: Thank you.

MR. BRIGHTBILL: I thought I would just add one thought, and that is as a trade lawyer, my perspective is if we can identify the barriers, we can start to address them. The U.S. Trade Representative needs to know exactly what the barriers are, in which industries, so whether it's pro basketball or steel or services, if we know what the barriers are, we can figure out do we have tools to address them? Can we bring a case at the World Trade Organization? Can we ensure that when China negotiates to join onto the WTO Government Procurement Agreement, that it actually opens all of these sectors?

Related to that is making sure that companies and industries can identify these barriers in a way that doesn't hurt them. Many of these companies have a grave fear of retaliation from China in one way or another if they speak up or identify these problems.

But I do think the more light you can shed, the more you can start to address some of these issues.

HEARING CO-CHAIR WESSEL: Thank you.

We will go for a second round, three minutes, if we can, for the questions and the answers. Commissioner Fiedler.

COMMISSIONER FIEDLER: Let me go back to the regulatory weeds. The examples you were using before, Canada, Australia, and if you threw in the UK, they have national registration systems for corporations. We in the United States have state-run systems.

The Chinese, if you look at their foreign direct investment, overseas investment, you would think that they own the Caribbean because most of the numbers are the Caymans and the British Virgin Islands.

Now, I understand I'm going to make my hedge fund friends angry about this, but there's no disclosure. We don't, you sit there, you tell me the Chinese don't have much money invested in the United States. I would tell you that you don't know because if most of their money is going to the BVI and the Caymans, there's no obligation that they have to disclose who they are when they buy something in the United States. Okay?

And I'm not talking publicly traded companies which have additional disclosure requirements about underneath who the large holders are. I'm talking privately held in the United States, not private, so state enterprises in China can go through the BVI, Caymans, come in here, and we don't know. If we're going to have any sort of regulatory regimen, I don't care what it is, it has to be based on information.

And why should we allow them to use the British Virgin Islands and the Caymans as a refuge? Why should we? I mean why can't we have some sort of disclosure in the United States on foreign corporations at least?

MR. BRIGHTBILL: Commissioner, I completely agree with that point. I'll defer to my colleagues, but you're right. When these Chinese companies run through numerous offshore formations, it's impossible to know the money going in, the structure, to know the nature and extent of the subsidies and other things. So it's a very serious problem.

COMMISSIONER FIEDLER: I mean I understand what I'm saying is because there's a lot of U.S. companies that use offshore havens, and I understand that there would be a dichotomy here, and the Chinese would rightfully say if we have to say who we are, then you should have to say who you are, and I think that is the political obstacle to what I'm talking about.

Any comment?

MR. SAULSKI: Other than I would agree that's a significant political obstacle and--

COMMISSIONER FIEDLER: Is that as an academic or as a SEC--

MR. SAULSKI: Yeah.

[Laughter.]

MR. SAULSKI: And generally, it basically goes against 75 years of our regulatory regime of treating issuers alike.

COMMISSIONER FIEDLER: Yeah, I mean, but gets back to what we were talking about and you were agreeing to, that the world has changed. And whether or not we should allow, when it was just some sort of hedge fund trying to hide a little money in the BVI versus state-owned companies now using the BVI to gain entrance and penetration into the United States.

Thank you.

HEARING CO-CHAIR WESSEL: I'll ask a quick question or what may be a quick question. U.S. is now engaged in the TPP talks, as we talked about, and the possibility for an SOE text is very real. Press reports have indicated that one of the issues is that there seems to be a concern about defensive interests in the U.S., meaning that there are some who believe that we have SOEs that are at risk and therefore how one develops a text could be a problem.

I hate to say, you know, I don't see any of our long-term SOEs, TVA or the Postal Service, as engaging in extraterritorial operations other than maybe, you know, express mail services, and our other issues relating to GM and Chrysler are investments that were done under prudential basis and are declining. They were a short-term issue.

What do you each see as a defensive--is this a real concern? How should we look at U.S. SOEs, if they are, versus other countries?

Mr. Brightbill?

MR. BRIGHTBILL: Yes. I don't believe that defensive issues are a serious concern and should not limit our ability to negotiate a very strong TPP provision on state-owned enterprises.

Certainly I think there would be an ability to make an exception for some sort of extraordinary action taken during an unprecedented financial crisis, but the kinds of SOEs that we're talking about here in the United States, as you say, TVA or the Post Office, are not, for the most part, they're not operating abroad so they wouldn't be part of the provisions we're trying to install anyway.

But I think U.S. negotiators are very comfortable that they can address this issue and that we don't have serious defensive concerns. All we're trying to do is have these enterprises operating on a commercial basis, either on their investment or on their operations in another TPP country, and also to have transparency, to have disclosure of what this investment is all about.

HEARING CO-CHAIR WESSEL: Okay. Thank you.

Any other quick responses? Commissioner Cleveland, did you have a second round?

HEARING CO-CHAIR CLEVELAND: I'd like to pursue this question of the sustainability of the model for a minute. In your testimony, Mr. Saulski, you talk about financial repression, and the fact that Chinese households have very limited places where they can park their family money. And so they deposit in large state-owned banks, which in turn lend to, at subsidized rates, to the SOEs.

So the Chinese have said that their intent, out of necessity, is to shift to consumer, a domestic consumption market rather than export led. Is that achievable if consumers--what subsidizes the SOEs if consumption goes up and savings go down? How do the SOEs survive?

MR. SAULSKI: Well, they won't, or at least not the ones that are only being propped up because of the subsidies. So, again, in order for China to really make this transition, they're going to need to address many of the inefficiencies and problems in their financial markets. One of the main ones is this control over interest rates.

In order to have truly a consumer-led market, investors need to be able to feel confident that they will not lose their life savings or lose significant amount of it, which basically they're forced to save more, understandably, because in order for them to meet their needs in the future, whether it's potential health needs or retirement or put their kids in college, they now have to save more because they realize that their savings will deplete over time.

And so in order to truly free up their consumer spending, that needs to be addressed. That will, of course, take significant bite out of the state-owned enterprises' ability to remain competitive if they do not have this subsidized capital.

DR. GORDON: Let me just add a bit of a different point here though. I'm of the view that most of the SOEs in China are inefficient; they're a problem for China; they're not a problem for us. These are the SOEs that are most likely to be in the category of the ones that go away, that the firms that we're talking about are firms that actually are getting more efficient and are able to compete.

They'll be the last to lose their privileges, and so I do think that it's going to be a very, very hard challenge to make this leap--it is not going to fully solve our problem because I think the support for national champions--and that's what I focused on in my testimony--does not go away easily or quickly even in this environment of a more aggressive effort to get the financial system under control.

HEARING CO-CHAIR CLEVELAND: Interesting. Thank you.

MR. BRIGHTBILL: Commissioner, just to add one point. At a broader level, not just on SOEs, but is the whole system sustainable? And again this is dangerous. It's a little outside the area of trade law only. But I do think it's, hopefully, it's unlikely that China can sustain and manipulate its currency forever, or that it will continue to grow at a ten percent rate forever, or that it will be able to censor the Internet forever. And so I think you have macro trends operating there as well, and perhaps some change would come when we all least expect it.

HEARING CO-CHAIR CLEVELAND: How do you define forever?

MR. BRIGHTBILL: I think I'll have to defer on that one.

HEARING CO-CHAIR CLEVELAND: Previous panels--

HEARING CO-CHAIR WESSEL: Since your time has run out--

[Laughter.]

HEARING CO-CHAIR WESSEL: --has expired.

HEARING CO-CHAIR CLEVELAND: The other panelists spoke in terms of between five and 30 years. Do any of you have estimates that would differ from that broad band?

MR. BRIGHTBILL: Commissioner, I really can't speculate on that. Thank you.

HEARING CO-CHAIR WESSEL: Gordon.

DR. GORDON: I think the Chinese really do begin to get in trouble on all of these things in the next five years. And I don't believe, I mean I don't think they have anything like decades here.

MR. SAULSKI: I agree, though we have to understand what do we mean by "trouble."

DR. GORDON: Right.

MR. SAULSKI: We're not talking about, you know, like some of the doomsayers--

DR. GORDON: Right.

MR. SAULSKI: --say about a collapse, a financial collapse or a crisis and a breaking up of China and social unrest. We're talking about a drop in their growth rate, which would pose significant challenges to China, which needs to grow extremely fast in order to compensate for their population.

HEARING CO-CHAIR CLEVELAND: Maybe it's a requirement for change less than trouble.

HEARING CO-CHAIR WESSEL: For the last question, Chairman Shea.

CHAIRMAN SHEA: Okay. I just want to compliment Dr. Gordon on using the word "lacuna."

[Laughter.]

CHAIRMAN SHEA: That's a great word. But my question is for you.

DR. GORDON: I'm trying to stay with my legal colleagues here, you know.

[Laughter.]

CHAIRMAN SHEA: This question is for you, and it's about speculation. In the fall, there will be the 18th Communist Party Congress, a lot of speculation about who's going to be on the Politburo Standing Committee, members of the Politburo, members of the Central Committee. We hear a lot about the different factions, the Shanghai faction, the Communist Youth League faction, the princeling faction.

Do you have any insights to share about the political influence of the SOEs in this process?

DR. GORDON: I think that the SOEs are a very, very, very diverse group, and I think that increasingly they are going to be in competition with each other. There's a lot of overlap. There are very different family interests involved. I don't think this is ideological. I don't like the notion of nationalist versus others. I don't think that captures it.

So I think, I think we're heading into a troubled political transition. I think that the two things that worry me about the direction we're heading in is, one, that nationalism that's always been strong in China is taking on an increasingly American, anti-American target. We've never been the target of nationalism in China historically. Now we are.

The second thing that I find really troubling is when I look at the foreign policy and the national security establishment, most of the senior people who are going to be leaving the scene in the next year had their formative life experiences during the period of triangular diplomacy and the opening with China, and they're nationalists, but they're not anti-American--Dai Bingguo, Professor Wang Ji-su, very close to President Hu.

We don't really know who's behind these people, and I do think that U.S.-China relations have the potential to be very, very, very rocky here, and that in this, getting a much better understanding of the sort of business-Communist Party nexus is going to be something very, very important if we're going to be able operate successfully in those realms.

CHAIRMAN SHEA: Thank you.

COMMISSIONER BARTHOLOMEW: Just one comment. First, thank you, all, for your testimony.

I have to react, Dr. Gordon, to the "things are going to be rocky," because for those of us who have been following U.S.-China policy--for me, it's over 20 years now. So I mean every time I hear it, I just kind of feel like people are always saying, well, we're in a rocky stage; we're in a difficult stage. I really can't think of a time where it wasn't like that over the--so it was just sort of cautionary.

Thank you.

HEARING CO-CHAIR WESSEL: Thank you. And we will adjourn until 1:45 for our next panel. Thank you to each of the panelists, very appreciative.

Panel III – Policy Options for Addressing Chinese State-Owned Enterprises

HEARING CO-CHAIR CLEVELAND: Our final panel will articulate potential policy options for addressing the challenges presented by China's SOEs at home and abroad. And after the testimony this morning, you have your work cut out for you.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: With us today is Elizabeth Drake, international trade attorney and partner at the firm of Stewart and Stewart.

Ms. Drake has broad experience in an array of international trade matters, including antidumping and countervailing duty proceedings, Section 301, China-specific safeguards, and there's a long list here, which we'll put in the record. You are very experienced.

She's represented clients in proceedings before the Department of Commerce, ITC, and U.S. Trade Rep. She's also advised clients on trade policy and legislative matters, as well as dispute settlement proceedings before the World Trade Organization.

She served for six years as a policy analyst at the AFL-CIO and advocated on behalf of American labor.

Let's see what else I think is interesting in your resume. You received your J.D. from Harvard. Not sure that's interesting, but we'll--

[Laughter.]

HEARING CO-CHAIR CLEVELAND: This part is. You got your B.A. in anthropology from the University of California. I think that's distinctive. Graduated with honors and Phi Beta Kappa.

Dr. Scissors, we know well. He focuses his studies on the economies of China and India, while analyzing broader economic trends.

He's testified in the House of Representatives on rare earths; U.S. Senate on exchange rate disputes. He's been a regular witness here, and we value his input.

His analysis and commentary is well known in Foreign Affairs, National Review, and there's also a long list here. So we'll skip that in the interest of time.

And Mr. Curtis Milhaupt, welcome. Parker Professor of Comparative Corporate Law and Fuyo Professor of Japanese Law at Columbia.

Your research interests have included comparative corporate governance, the legal systems of East Asia. You've published widely in the fields of comparative corporate governance and Japanese law, perhaps setting an example for us of how we should proceed, as well aspects of Chinese and Korean legal systems.

You have authored a number of books, and your research is frequently profiled in The Economist, Financial Times, and many other distinguished publications at Columbia.

You were appointed the Albert Cinelli Enterprise Professor of Law, and you received--did you get your B.A. in anthropology--next page?

[Laughter.]

HEARING CO-CHAIR CLEVELAND: No.

COMMISSIONER BARTHOLOMEW: But I did.

HEARING CO-CHAIR CLEVELAND: University of Notre Dame in 1984, and your J.D. from Columbia where you were the editor of the Columbia Law Review.

So, welcome to all of you. We started right to left last time. Let's start left to right this time. Anthropologists first.

STATEMENT OF ELIZABETH J. DRAKE
PARTNER, STEWART AND STEWART, WASHINGTON, DC

MS. DRAKE: Thank you so much, Commissioner.

Good afternoon, Commissioners. My name is Elizabeth Drake, and I'm a partner at the Law Offices of Stewart and Stewart. Thank you for the opportunity to testify before you today.

The government of China's aggressive support policies can create an unfair advantage for Chinese SOEs in the Chinese market, in the U.S. market and third-country markets. The scope of the problem requires a comprehensive U.S. response.

I would like to focus today on three ways the U.S. can help level the playing field between American industries and Chinese state-owned enterprises:

First, confront Chinese government subsidies to SOEs; second, challenge Chinese SOEs' use of purchasing and joint venture agreements to favor domestic over foreign suppliers, and to leverage technology transfers and other concessions from U.S. firms; and, third, correct anti-competitive and unfair trade practices by state-owned enterprises.

In each area, I hope to identify opportunities to better enforce existing rules, as well as opportunities to create new rules where the current system does not adequately address the problem.

On the issue of subsidies, the extent of government support to SOEs is well documented. Export credits are just one example. China provides an estimated $100 billion in export credits each year, making it by far the world's largest provider.

In 2010, China ExIm gave three times as much new lending support as U.S. ExIm. Many of these credits are provided at rock bottom interest rates, sometimes as low as one or even zero percent. China has refused to join the OECD arrangement on export credits or to comply with its terms in practice, and state-owned enterprises are major beneficiaries of these programs.

Yesterday's announcement that the U.S. and China will work towards a separate agreement on export credits may actually represent a step backward from the OECD rules that China has refused to join.

Indeed, a strong case can already be mounted against these export credits under existing WTO rules that prohibit export subsidies. Where such credits do not comply with OECD terms, they are, per se, prohibited, and no injury need be shown to prevail at the WTO.

Other subsidies which are not prohibited, such as cut-rate bank loans and land concessions, can also be challenged at the WTO if they are depressing prices and impeding sales for U.S. exporters. While such cases are more fact intensive, a successful challenge would deliver significant benefits.

China has also agreed to additional rules that prohibit its SOEs from providing inputs to one another at discounted prices. These rules cover goods and services, and they do not require any showing of injury. They should be aggressively enforced.

Finally, the harm that subsidies to SOEs cause in the U.S. market must be effectively redressed. Congress must act quickly to correct a recent U.S. court decision, GPX v. U.S., that prevents the application of our countervailing duty law to imports from China. The decision puts 23 orders and five pending investigations at risk, affecting more than 80,000 direct production jobs, and it requires urgent action.

The second challenge posed by Chinese SOEs is their use of purchasing contracts and joint venture agreements to discriminate against U.S. suppliers and demand concessions such as technology transfer.

My written testimony cites numerous examples of such practices. In the telecom sector, for example, China Unicom's state parent gets three percent of each procurement contract when it buys domestic goods, but only one percent when it buys imported goods. This creates a strong incentive for them to discriminate against foreign suppliers.

In another example, state-owned Sinovel required its supplier, American Superconductor, to shift the sourcing of certain wind turbine components to China as a condition of the supply contract. After American Superconductor complied, Sinovel stole the company's trade secrets so it could produce the technology itself.

Fortunately, fairly robust rules in China's WTO Accession Protocol directly address these issues. These rules require China to ensure its SOEs act consistently with commercial considerations and in a non-discriminatory manner when making purchasing and sales decisions.

The rules also prohibit China from influencing the commercial operations of its SOEs or requiring local content or technology transfers as a condition for investment approvals.

Unfortunately, these important provisions have never been tested. It is far past time that China be held to the rules that it agreed to.

Finally, there are significant gaps in competition and unfair trade policies that permit Chinese SOEs to gain an unfair advantage over commercial competitors. While ensuring that China's own domestic competition regime is even-handed would require agreement from China, of course, the U.S. can close gaps in our own laws unilaterally, and we should.

For example, under U.S. antitrust laws, pricing practices are only considered anti-competitive if the predator is likely to recoup its losses after its competitors are driven from the market. This is the so-called "recoupment test." SOEs, however, can afford to never recoup such losses if the state offers them sufficient support, and such support may be readily available if the predatory pricing will help the SOE gain access to key suppliers, technologies, brand names or other assets to further the state's political and industrial policy goals.

My written testimony suggests additional improvements may be needed in the CFIUS screening process for foreign investment by SOEs, in SEC reporting rules, and in domestic trade remedy laws. In addition, the U.S. should work on enhancing rules in these areas multilaterally on the basis of OECD guidelines on state-owned enterprises and regionally in fora such as the ongoing TPP negotiations.

In closing, I believe we have many policy options for addressing the competitive challenges posed by Chinese SOEs. More vigorous enforcement can go a long way towards addressing the most egregious abuses. Where new rules are needed, the U.S. should develop a strategy that will help our firms and workers compete as Chinese SOEs continue to exert their influence in markets around the world.

Thank you very much.

PREPARED STATEMENT OF ELIZABETH J. DRAKE
PARTNER, STEWART AND STEWART, WASHINGTON, DC

Chinese State-Owned and State-Controlled Enterprises:
Policy Options for Addressing Chinese State-Owned Enterprises
Testimony before the U.S. – China Economic and Security Review Commission
Elizabeth J. Drake
Partner, Law Offices of Stewart and Stewart
February 15, 2012

I. Introduction

State-owned and state-controlled enterprises ("SOEs" collectively) in China present a number of policy challenges. The Government of China's aggressive support policies create an unfair advantage for Chinese SOEs in the Chinese home market, in the U.S. market, and in third country markets. The scope of the problem requires a comprehensive U.S. response, one that combines elements of trade policy, investment policy, and domestic competition policy.

While reducing or eliminating state ownership and control in some sectors of China's economy may be a desirable goal, it will likely be very difficult to achieve in the near future, especially in those pillar and strategic sectors where the Government of China has announced its intention to maintain or increase the role of SOEs. These sectors include, at a minimum, defense, electric power, telecommunications, oil and coal, civil aviation, shipping, equipment manufacturing, automobiles, information technology, construction, iron and steel, non-ferrous metals, and chemicals. In its *12th Five-Year Plan*, China identified many of these as "Strategic and Emerging Industries" in which the government plans to invest $1.5 trillion over the next five years.

This testimony seeks to identify policies that would help to neutralize the competitive advantage that Chinese SOEs enjoy in these sectors. The U.S. and other major market economies have endorsed this principle of competitive neutrality at the OECD and elsewhere, and the policies discussed herein seek to meet that goal. The sections below are organized into three major areas in which Chinese government policies and practices regarding SOEs distort markets.

1. Government subsidies to SOEs, including subsidized loans, export credits, debt forgiveness, grants, equity infusions, and preferential access to key inputs such as land, utilities, and raw materials.

2. Chinese SOEs' use of purchasing and joint venture agreements to favor domestic suppliers, goods, and services over foreign suppliers, goods, and services or to leverage technology transfers and other concessions from U.S. firms.

3. The failure to adequately address anti-competitive and unfair trade practices by SOEs, including under China's own competition policies as well as the policies of countries that are increasingly targeted for overseas expansion by SOEs.

Fortunately, there are many tools that already exist for confronting the competitive challenges posed by Chinese SOEs. However, there are a number of areas in which the current set of rules does not adequately address the problem. These comments highlight those areas in which current rules can be more effectively enforced, and they also seek to identify gaps in the current system and propose possible approaches to filling those gaps.

II. Government Subsidies to SOEs

SOEs in China enjoy significant advantages due to their preferential access to credit and debt forgiveness from state-owned banks, to government-owned land, and to electricity, water, and raw materials from other SOEs. Other subsidies include equity infusions and an exemption from paying full dividends to state shareholders. These subsidies permit SOEs to add capacity, produce more and better products, and sell at lower prices than would otherwise be possible.

One area in which SOEs have received tens of billions of dollars of government support is through concessional export credits and export credit guarantees. The U.S. Ex-Im Bank estimates that China Ex-Im and the China Development Bank provide as much as $100 billion in export credits each year, making China by far the largest export financier in the world.[76] China's annual export credit financing is thus the same as the total cumulative exposure limit for U.S. Ex-Im.[77] Indeed, in 2010, China Ex-Im issued more than three times as many new medium- and long-term export credits as U.S. Ex-Im.[78] While the terms of China's export financing are far from transparent, the People's Bank of China publishes rates for certain Ex-Im credits that are typically about two percentage points below the Bank's already depressed "market" benchmark rate, and other sources indicate Ex-Im financing is available at rates as low as two, one, or even zero percent.[79]

Chinese SOEs routinely benefit from these export credits and guarantees. Infrastructure and power projects have been a major focus of support, and both sectors are dominated by SOEs. Sinohydro, for example, a state-owned hydropower firm that has benefitted from significant Ex-Im support, is involved in more than half of all hydropower projects underway around the world.[80] In the telecommunications arena, ZTE, a major state-owned firm, and Huawei, a firm widely believed to have ties to the state, have received more than $50 billion in export financing from the China Development Bank and China Ex-Im; the companies have also signed strategic cooperation agreements with Sinosure to expand their use of export credit guarantees.[81]

Export credits and guarantees are just one example of massive government subsidies to Chinese SOEs. Fortunately, rules already exist to discipline these subsidies and remedy the harm that they cause.

---

[76] Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2011) at 113.
[77] "White House Explores Export Financing Options, But Faces Obstacles," *Inside U.S. Trade* (Feb. 2, 2012).
[78] Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2011) at 11.
[79] Terence P. Stewart, et al., *China's Support Programs for Automobiles and Auto Parts under the 12th Five-Year Plan* (Jan. 2012) at 60.
[80] Yang Wanli, "Sinohydro: top hydropower engineering firm," *China Daily* (Oct. 20, 2009).
[81] Terence P. Stewart, et al., *China's Support Programs for High-Technology Industries under the 12th Five-Year Plan* (June 2011) at 136 – 137.

A. Enforcing Existing Subsidy Rules

Where government benefits are conditioned on export performance or domestic content, they are prohibited by the WTO Agreement on Subsidies and Countervailing Measures ("SCMA").[82] The export credits and export credit guarantees discussed above are prohibited export subsidies, because they are granted by the government, conditioned on export performance, and provided at below-market rates. While the SCMA provides a safe haven for export credits that conform to the terms of the *OECD Arrangement on Export Credits*, China has refused to sign on to the OECD rules. In addition, as noted by U.S. Ex-Im, most of the terms and conditions of China Ex-Im's financing "*did* not and *do* not fit within the OECD guidelines."[83] The SCMA also lists export credit guarantees that are provided at a loss as an example of a prohibited export subsidy – Sinosure has operated at a cumulative loss since its founding in 2002.[84] Given the scale of these export subsidies, a WTO case challenging these practices could have major benefits for U.S. firms. The evidence supporting a case is strong, and China would bear the burden of demonstrating that its programs are consistent with OECD rules to defend its practices. In addition, it is not necessary to show that these support programs have any harmful effects to prevail in a WTO challenge; as export subsidies, they are *per se* prohibited.

WTO rules also discipline subsidies that are not contingent on exports or domestic content. These so-called domestic subsidies are actionable under the SCMA where they are limited to a group of industries (such as SOEs), provide a benefit, and cause serious prejudice.[85] Serious prejudice exists if the subsidies: 1) displace or impede U.S. exports to China or third country markets; 2) cause significant price undercutting, suppression, or depression or lost sales in any market (China, the U.S., or third country); or 3) increase China's share of the world market in a primary product or commodity.[86] A successful WTO challenge would require China to withdraw the subsidies in question, eliminate their harmful effects, or face the retaliation.

While the evidence of concessional lending and other domestic subsidies to Chinese SOEs is overwhelming, a successful WTO challenge would also require showing serious prejudice, which would likely require industry support and increased USTR enforcement resources to build the necessary factual record. Where the will exists to present such evidence, the WTO system has proven itself capable of disciplining domestic subsidies as it recently did in the Airbus and Boeing cases. In addition, the WTO Appellate Body recently affirmed that one of the primary forms of government support to Chinese SOEs, loans from Chinese state-owned banks at below market rates, are indeed subsidies under SCMA rules and that market interest rates from outside of China may be used to measure the benefit conferred by such loans.[87] While challenges to actionable subsidies may be ambitious, they offer the only hope of confronting the severe competitive disadvantage that vast government support for Chinese SOEs poses to the U.S. firms

[82] WTO Agreement on Subsidies and Countervailing Measures ("SCMA"), art. 3.
[83] Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2010) at 99 (emphasis in original).
[84] Terence P. Stewart, et al., *China's Support Programs for Automobiles and Auto Parts under the 12th Five-Year Plan* (Jan. 2012) at 64 – 65.
[85] SCMA, arts. 1, 2, and 5.
[86] SCMA, art. 6.
[87] *United States – Definitive Anti-Dumping and Countervailing Duties On Certain Products From China*, WT/DS379/AB/R (March 11, 2011).

seeking to compete in China and third country markets.

The SCMA only disciplines subsidies that distort trade in goods. Fortunately, China agreed to additional provisions disciplining certain subsidies that disadvantage U.S. service providers and investors. Section 3 of China's Protocol of Accession, for example, requires China to accord foreign enterprises treatment national treatment in respect of the prices and availability of goods and services supplied by government authorities and state enterprises in areas including energy, utilities, and other factors of production. Thus, to the extent that SOEs are able to access these inputs at quantities and rates not available to foreign firms in China, the U.S. could challenge the practices as a direct violation of China's Protocol. China also agreed to ensure all SOEs "make … sales based solely on commercial considerations, *e.g.*, price, quality, marketability and availability," and foreign enterprises must also "have an adequate opportunity to compete for … purchases from these enterprises on non-discriminatory terms and conditions."[88] The rule thus explicitly prohibits the provision of key inputs by SOEs at below-market rates. A successful case under either of these provisions would not require an injury showing.

Finally, the U.S. must ensure it can remedy the harm that subsidies cause in the U.S market. Unfortunately, that ability has been thrown into doubt by a recent decision from the U.S. Court of Appeals for the Federal Circuit, *GPX International Tire Corp. v. United States*, Nos. 2011–1107, –1108, –1109, slip op. (Fed. Cir. Dec. 19, 2011). The *GPX* court ruled the U.S. may not apply the countervailing duty law to subsidized imports from China, because China is treated as a non-market economy under the antidumping law. The decision puts 23 countervailing duty orders on imports from China at risk, as well as five on-going investigations. While it is possible that the decision may be corrected on appeal, the surest way to restore the integrity of the countervailing duty law is for Congress to enact a targeted legislative fix that corrects the decision as quickly as possible.

B. Strengthening Anti-Subsidy Rules

When legal certainty regarding U.S. countervailing duty law is restored, there are a number of steps that could make that law more effective at combatting subsidies to SOEs. The Department of Commerce has rightly recognized that subsidies which are limited to SOEs as a group are "specific," and thus countervailable. Commerce, however, unnecessarily weakens the effectiveness of the law through various methodologies, such as the adjustments it applies to reduce the duties applied to offset subsidized loans. In addition, the Administration should explore making greater use of its power to self-initiate countervailing duty cases, particularly in sectors where domestic industries are being injured but are too fragmented, under-resourced, or intimidated by threats of retaliation to invoke their legal rights and petition for relief.

The U.S can take additional actions to protect U.S. industries from competition with subsidized imports even where no countervailing duty orders apply. For example, Buy America laws permit agencies to purchase foreign products where the foreign good is significantly less expensive than competing American goods. These rules could be revised to eliminate this flexibility where the foreign good in question is produced or exported by an SOE or other enterprise that receives

[88] *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (Nov. 10, 2011) at paras. 46, 342; *Accession of the People's Republic of China*, WT/L/432 (Nov. 23, 2011) at Sec. 1(2).

foreign government support. Such a change would likely be permitted under WTO rules unless and until China becomes a member of the Government Procurement Agreement.

Additional rules to address the harm that subsidies to SOEs can cause U.S. firms would likely require new negotiations with China, whether at the WTO or bilaterally. The *OECD Guidelines on Corporate Governance of State-Owned Enterprises* offer guidance in this area. For example, Chapter I of the *Guidelines* states that governments should ensure a "level playing field" in markets where SOEs and private companies compete "in order to avoid market distortions."[89] Thus, "SOEs should face competitive conditions regarding access to finance," and SOEs' relationships with state-owned banks and other SOEs "should be based on purely commercial grounds."[90] Notably, the principle does not contain an injury test – it is a *per se* rule that requires SOEs to be subjected to the same competitive conditions that private firms face.

On-going negotiations over competition rules in the Trans-Pacific Partnership ("TPP") Agreement also offer an opportunity to establish a high standard that would set the baseline for new rules to discipline subsidies to Chinese SOEs. Proposals to include a commitment to operate SOEs in accordance with *OECD Guidelines* would be a step in the right direction. In addition, the TPP could limit the extent of government assistance to SOEs (with possible carve-outs for SOEs' non-commercial operations, national emergencies, and other negotiated exceptions), and, at a minimum, require transparency and regular reporting regarding the extent of such assistance.

A more robust regime would require parties to submit comprehensive annual notifications listing all SOEs in which they have an ownership or control interest, identifying the markets in which such SOEs operate and their market shares, detailing all forms of government support to such SOEs, and disclosing the terms of major procurement and supply contracts entered into by such SOEs. Such notifications should be subject to review by a standing working group and questions from the parties concerned. The format could be similar to notification regimes at the WTO for subsidies, state trading enterprises, technical barriers to trade, and other trade-related matters.

III. SOE Procurement and Contracting Practices

A. Discriminatory and Distortionary Purchasing and Contracting Practices

Chinese SOEs expand their influence in the market by discriminating against U.S. suppliers, goods, and services in their procurement decisions and by using their leverage in supply and joint venture negotiations to force technology transfers and other concessions.

In the telecommunications sector, for example, China's big three state-owned operators reportedly purchase under a government directive to buy domestic components and equipment.[91] The government also encourages the use of domestic over imported telecommunications

---

[89] *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, Ch. I, chapeau.
[90] *Id*. at Ch. I, Sec. F.
[91] United States Trade Representative, *2011 National Trade Estimate Report on Foreign Trade Barriers* (March 2011) at 64.

equipment by directing telecom operators to support indigenous innovation.[92] In 2009, for example, service licenses granted to China Telecom, the largest mobile service provider in China, mandated the use of the TD-SCDMA standard, an indigenous standard developed with support from Government of China.[93] The government's policy is also reflected in the telecom operators' own purchasing arrangements. China Unicom, for example, purchases equipment through contracts with its state-owned parent, and it warns investors that the arrangement may not be in the best interests of shareholders.[94] Under the arrangement, the state-owned parent gets three percent of the contract cost for purchases of domestic equipment but only one percent of the contract cost for imported equipment,[95] creating an incentive for the parent company to procure equipment from domestic producers even if it is more expensive than imported equipment. As a result of these policies, domestic manufacturers dominate important segments of China's telecommunications market, supplying at least two-thirds of the 3G market and over 80 percent of the TD-SCDMA market.[96]

Discrimination also appears in the form of domestic content provisions in Chinese SOEs' sourcing and joint venture contracts. In the wind-energy sector, for example, the state-owned producer Sinovel contracted to purchase wind turbine components from American Superconductor for delivery from 2009 to 2011. The contract set out a "localization schedule" under which converters which American Superconductor had produced with imported material would instead be produced with domestic materials.[97] By 2010, American Superconductor reported that it had successfully localized the supply of components for its converters to China.[98] More recently, as part of an agreement to establish a joint-venture with a Chinese SOE to produce trucks in China, Daimler similarly agreed to "localize" the production of the truck engines to China.[99]

SOEs in China also use their market position to negotiate technology transfer provisions in joint venture agreements with foreign partners. State-owned firms in the natural gas, coal, automotive, and solar industries, among others, have obtained technology transfer concessions from U.S. investors in a range of joint venture agreements.[100] Chinese SOEs have also obtained

---

[92] In 2008, when the Chinese government consolidated its telecom operators into the three state-owned entities, it encouraged all "relevant departments, enterprises, and institutions to give priority to indigenously innovated products," and it stated that "state-owned assets management departments shall use indigenous innovation as a key criterion in assessing telecom operators." Ministry of Industry and Information Technology, National Development and Reform Commission, Ministry of Finance, *Notice on Deepening the Telecom Reform* (May 24, 2008) at Sec. III.
[93] Xudong Gao, *Understanding Key Features of the TD-SCDMA Adoption Process in China* (2009) at 19; Jenn-hwan Wang and Ching-jung Tsai, *How Does China Restructure Global Production Networks?* Paper presented at 2010 Industry Studies Conference (ISA), University of Illinois at Chicago, May 6-7, 2010; "Datang receives another CNY 20 billion line of Credit," *ChinaTechNews.com* (July 27, 2007).
[94] China Unicom 2008 Form 20-F at 10.
[95] China Unicom 2009 Form 20-F at 83.
[96] DBS Vickers Securities, *Hong Kong / China Industry Focus: China Telecom Sector* (Feb. 24, 2010).
[97] American Superconductor Corp. Form 8-K (June 5, 2008) at Ex. 10.1.
[98] American Superconductor Corp. Form 10-Q (Aug. 5, 2010) at 18.
[99] "Germany's Daimler to Make Trucks in China," *Agence France Presse* (Spet. 26, 2011); "Final Approval Issued by Chinese Authorities: Way Clear for Daimler's Truck Joint Venture with Foton," Daimler.com (Sept. 26, 2011).
[100] *See*, *e.g.*, IMPCO Technologies Inc. Form 10-K (2002) at 4-5, 8, Ex. 10.64; Evergreen Solar, Inc. Form 8-K (July 30, 2009) at item 1.01, Ex. 99.2; Evergreen Solar, Inc. Form 10-Q (Nov. 10, 2009) at 28-30, Ex. 10.1-10.7; Equity Joint Venture Contract for the Establishment of BMW Brilliance Automotive Ltd. by and between BMW Holding BV and Shenyang JinBei Automotive Industry Holding Co., Ltd. (2003) at arts. 1.47, 4, 12; Valence Technology

concessions to gain access to foreign partners' global supply chains as part of joint venture agreements.[101] These concessions are often facilitated by government rules that limit the extent of foreign equity participation in the market or grant preferential treatment to SOEs.[102]

B. Enforcing Existing Rules

Fortunately, China has already agreed to relatively robust rules prohibiting these types of discriminatory and distortionary purchasing and contracting policies by SOEs. Article III:4 of the GATT prohibits discriminatory treatment of imported goods – while there is a limited carve-out to this obligation for government purchases of goods for governmental purposes, the exception does not apply when SOEs procure goods for commercial purposes. Nor is there any exemption for SOEs outside of the purchasing context, such as in their negotiation of joint venture agreements. National treatment obligations in the GATS have a similar scope, though they only apply to sectors in which members have made positive commitments.

China has made additional, specific commitments to respect the principle of non-discrimination in SOE purchasing decisions. In its Protocol of Accession and accompanying Working Party Report, China agreed that SOEs shall make purchases based solely on commercial considerations, that foreign enterprises will have an adequate opportunity to compete for such contracts on a non-discriminatory basis, that China will not influence, directly or indirectly, the purchasing decisions of SOEs, and that SOEs' commercial purchases will not be subject to government procurement exceptions.[103] These commitments apply to purchases of both goods and services, and they appear to require non-discrimination not only for imports but also for foreign-invested firms in China.

China has also agreed not to implement domestic content or technology transfer requirements as a condition of investment approvals.

> China shall eliminate and cease to enforce … local content and export or performance requirements made effective through laws, regulations or other measures. Moreover, China will not enforce provisions of contracts imposing such requirements …. China shall ensure that … any other means of approval for … the right of … investment by national and sub-national authorities, is not conditioned on … 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.[104]

Inc. Form 10-Q (2003) at 12-13, JV Contract at art. 9; Synthesis Energy Systems Inc. Form 8-K (2009) at item 1.01, Exs. 10.1 & 99.1.

[101] *See*, *e.g.*, General Motors, *2010 Annual Report* at 62.

[102] In the automotive sector, for example, foreign investors in complete automobile production are required to enter into a joint venture in which the Chinese partner owns at least 50 percent. *Automotive Industry Development Policy*, State Council Document Guo Han [2004] No. 30 (May 21, 2004) at Art. 48. In other sectors such as energy and infrastructure, SOE dominance is so widespread that foreign investors face few options to enter the market aside from joint ventures with SOE control.

[103] *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (Nov. 10, 2011) at paras. 46, 47, 342; *Accession of the People's Republic of China*, WT/L/432 (Nov. 23, 2011) at Sec. 1(2).

[104] *Accession of the People's Republic of China*, WT/L/432 (Nov. 23, 2011) at Sec. 7(3).

It appears that China is directly violating these commitments in its telecommunications, energy, and automotive sectors at a minimum, and likely in many other SOE-dominated sectors as well. These obligations should be rigorously enforced. While some cases may be fact-intensive and require information on specific contracts and transactions, other violations appear to be a matter of formal policy that could be more easily challenged at the WTO.

IV. Anti-Competitive and Unfair Trade Practices

A. China's Domestic Competition Regime

Under the Anti-Monopoly Law adopted by China in 2007, the state shall "protect the lawful business activities" of SOEs in industries that implicate national economic vitality and national security, and the state shall regulate such SOEs' business operations not only to safeguard consumer interests but also to "promote technological progress."[105] While the law also notes that SOEs should not abuse their market dominance to the detriment of consumers, it has been unclear in practice how this provision would be enforced against SOEs, if at all.

In the fall of 2011, reports indicated the National Development and Reform Commission was investigating anti-competitive behavior by two major telecom SOEs, China Unicom and China Mobile.[106] The two providers were allegedly charging prices for access to their broadband backbone networks that were higher for competitors in the broadband access business than for internet operators.[107] It is too early to determine whether the cases signal a willingness to subject SOEs to competition disciplines in an even-handed manner. As a preliminary matter, the case may be more about competition among SOEs rather than between state and private firms, as many of the broadband access network operators harmed by the anti-competitive conduct are themselves state-owned.[108] In addition, it appears that there has been little progress in the case since the NDRC submitted its investigation to the People's Supreme Court, the Ministry of Industry and Information Technology (which oversees the telecom industry), and the Legal Affairs Office of the State Council in November of last year.[109] Conflict among these agencies is what reportedly led the NDRC to reveal its investigation to the news media in China.[110] Shortly thereafter, the two SOEs involved pledged to increase access, reduce rates, and correct improper charges, and the decision whether or not to continue with the investigations remains pending.

Current trade and investment rules are likely inadequate to address preferential treatment that China's SOEs may receive under China's antitrust laws. The *OECD Guidelines* again provide a useful starting point: "SOEs should not be exempt from the application of general laws and regulations. Stakeholders, including competitors, should have access to efficient redress and an

---

[105] *Anti-Monopoly Law of the People's Republic of China* (Aug. 30, 2007) at art. 7.
[106] "Anti-Monopoly Investigations Should be Conducted Openly and Independently," *New China Magazine* (Jan. 2012).
[107] "Chinese Antitrust Enforcement Agencies Ready to Show Teeth to Large State-Owned Enterprises?" *China Law Insight* (Sept. 26, 2011).
[108] *Id*.
[109] "Anti-Monopoly Investigations Should be Conducted Openly and Independently," *New China Magazine* (Jan. 2012).
[110] *Id*.

even-handed ruling when they consider that their rights have been violated."[111] In the specific area of competition policy, the U.S.-Singapore FTA also provides a possible model. It requires the Government of Singapore to ensure that its SOEs refrain from certain anti-competitive conduct such as agreements to restrain price or output or allocate customers and exclusionary practices that substantially lessen competition to the detriment of consumers.[112] While application of such rules to the Chinese marketplace would require agreement with the Government of China, the TPP Agreement again offers an important opportunity to develop model rules that could form the starting point for any such negotiations.

B. Competition with Chinese SOEs as Investors in the U.S. and Abroad

U.S. firms also face competition from Chinese SOEs that establish a commercial presence in the United States or third countries. The Government of China actively encourages SOEs to expand their presence abroad as part of the "Going Global" strategy.[113] Since China joined the WTO in 2001, its annual foreign direct investment flows to the rest of the world have increased ten-fold, and SOEs account for the majority of China's outbound investment.[114] While foreign investment can support job creation and economic growth, such investors should not be permitted to take advantage of their state backing to distort foreign markets and undermine competition.

Rising overseas investment by Chinese SOEs poses a number of policy challenges. First, government support for Chinese SOEs may give them an unfair advantage as investors in overseas markets. As noted in section II, above, current rules primarily discipline government subsidies to the extent they affect trade in goods – subsidies that distort international investment flows in the U.S. and third countries are not the subject of binding rules. Such rules would require negotiation with China, and could draw upon principles of competitive neutrality enshrined in the *OECD Guidelines* and proposed for the TPP Agreement.

Absent such rules, there are other steps that the U.S. can take to address the advantages Chinese SOEs may enjoy as overseas investors. In the U.S. market, the U.S. should undertake a review of the screening rules employed by the Committee on Foreign Investment in the United States ("CFIUS"), U.S. antitrust laws, SEC reporting requirements, and unfair trade statutes to ensure they adequately address the challenges posed by a growing SOE presence in the U.S.

U.S. antitrust laws merit particular attention. On predatory pricing, for example, the OECD notes that the U.S. recoupment test, under which pricing is only deemed anti-competitive if the predator is likely to eventually collect enough profits to make up for the losses caused by the predatory behavior, may fail to account for competition from SOEs.[115] SOEs do not face the same market discipline or incentives as private firms. They can rely on state support to maintain

---

[111] *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, Ch. I, Sec. D.
[112] U.S.-Singapore FTA, art. 12.3(2)(d)(ii).
[113] Wayne M. Morrison, *China's Economic Conditions*, Congressional Research Service (June 24, 2011) at 20.
[114] *Id*. *See also* United Nations Conference on Trade and Development, "Inward and Outward Foreign Direct Investment Flows, Annual," *UNCTADStat Database*.
[115] Antonio Capobianco and Hans Christiansen, "Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options," *OECD Corporate Governance Working Paper No. 1* (2011) at 21. The test is based on the theory that a predator who could not recoup its losses would either not engage in the predatory practices to begin with or will eventually exit the market, causing no long-term damage to competitors or consumers.

losses that may never be recouped in order to meet political or industrial policy goals, or secure access to key suppliers, leading technologies, brand names, and other assets. Alternative predatory pricing rules, such as those based on cost benchmarks, may provide better safeguards for competition in such cases. Government support for SOEs and their central role in carrying out Chinese industrial policies should also be taken into account when the Department of Justice reviews proposed mergers and acquisitions for competition concerns.

U.S. trade remedy laws may also need to be strengthened to ensure SOEs cannot use commercial presence to circumvent antidumping or countervailing duty orders. Under current law, for example, an order may be expanded to cover imported parts that are used to assemble merchandise in the U.S. that would otherwise be subject to unfair trade duties.[116] Relief is only available if the assembly is insignificant and the value of imported components is a significant portion of total value. Commerce also considers affiliation between the U.S. assembler and the component exporter and whether imports of components have increased, among other factors. These rules may need to be revisited to ensure they fully redress any instances in which SOEs invest in the U.S. to evade trade remedies, including where the SOE's operations in the U.S. are not insignificant and where the SOE is not affiliated with a Chinese exporter.

The CFIUS process is another tool that could help level the playing field with SOE investors. While CFIUS applies heightened scrutiny to transactions involving SOEs, it only reviews foreign investment for national security purposes, not for economic policy reasons. Some have suggested that CFIUS could incorporate an economic aspect to its screening process, similar to the net benefit test employed by Canada. Alternatively, CFIUS or a process similar to CFIUS could be used to review SOE investments from a competitive neutrality standpoint, require disclosure of material information such as levels of government support and pricing practices, and regularly monitor investments for compliance with competitive neutrality principles.

In addition, many SOEs eager to access U.S. investment capital are now listed on U.S. stock exchanges. They are thus subject to the disclosure rules of the SEC, which can also provide a tool for leveling the playing field. The *OECD Guidelines*, for example, state that SOEs should disclose material information on all matters described in the *Guidelines*, including "[a]ny financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE," material transactions with related entities, and material risk factors.[117] As noted above, at least one Chinese SOE, China Unicom, felt the risk posed by discriminatory procurement policies was material enough to require disclosure – other SOEs should be held to the same standard. The terms of state assistance to SOEs should be disclosed in sufficient detail to permit investors to assess the risk countervailing duty liability or other trade action; the rates and terms of loans from state-owned banks, supply contracts with state-owned suppliers, land concessions, and similar information is all material to such an assessment.

Options for addressing competitive challenges posed by SOEs in third country markets may be more limited. If, however, competition rules in the TPP Agreement require governments to ensure that SOEs operate under conditions of competitive neutrality, it would be worthwhile to consider how those rules can be adapted to ensure that the same principle applies to all SOEs

---

[116] 19 U.S.C. Sec. 1677j(a).
[117] *OECD Guidelines on Corporate Governance of State-Owned Enterprises,* Ch. V, Sec. E.

operating in the covered markets, not just those SOEs owned by the host country government.

V. Conclusion

Chinese SOEs pose a major challenge to U.S. firms and workers seeking to compete in China's market, in the U.S. market, and in third countries. Fortunately, many rules already exist which could be more energetically enforced to neutralize the unfair advantage Chinese SOEs enjoy. These include subsidy disciplines and non-discrimination rules at the WTO, as well as specific WTO commitments China has made to ensure its SOEs act consistently with commercial considerations and in a non-discriminatory manner when making purchasing and sales decisions, not to influence the commercial operations of SOEs, and not to require local content or technology transfers as a condition of investment approvals. The U.S. also needs to correct the *GPX* decision and ensure the countervailing duty law can be effectively used to remedy the injury caused by subsidized imports from China.

In some areas the unique challenges posed by Chinese SOEs may require new rules, whether at the WTO, in bilateral or regional agreements, or in domestic law. The *OECD Guidelines* set out competitive neutrality principles that could be incorporated into such rules, as do the competition provisions of FTAs with Korea and Singapore. In addition, the U.S. should review its antitrust rules, unfair trade laws, SEC reporting requirements, and CFIUS regime to determine if additional steps are required to more fully address the competitive challenges posed by China's growing state-owned sector.

HEARING CO-CHAIR CLEVELAND: Thank you.

Dr. Scissors.

STATEMENT OF DR. DEREK SCISSORS
RESEARCH FELLOW IN ASIAN ECONOMIC POLICY
THE HERITAGE FOUNDATION, WASHINGTON, DC

DR. SCISSORS: Thank you.

I'm glad to be back. I'm glad you guys are doing this. There is a lot of ground to cover on SOEs, and it requires a lot of research, and so the more attention that's paid to it the better.

I'm going to do the same thing as my colleague did and split into U.S. market, overseas markets, third markets and China. I'm not going to talk about U.S. legal responses because I believe I'm flanked by two lawyers, and they would gang up on me if I did. But I do think the background of SOEs is relevant to the legal challenge.

SOEs are enabled to behave in an anti-competitive fashion at home. And home in this case is a very big market that makes for very big firms. I'm not sure the U.S. has seen this kind of challenge before where not just an anti-competitive firm and not just a big firm, but a big anti-competitive firm. That is a tough case to try to deal with.

So, Commissioner Wortzel has already attacked me viciously for not proposing enough solutions, and I'm not going to propose a solution to that either.

[Laughter.]

DR. SCISSORS: In most cases, we're not seeing that now. I do study Chinese investment in the U.S. at great length, and we're not seeing SOEs in the U.S. operate in this distortionary fashion now. So I don't mean to imply that, all right, we're on the verge of some disaster. I just mean that potentially this is a problem that we have not faced yet.

CFIUS. I don't like CFIUS. It's not as transparent as it should be, as it could be. There are going to be things that aren't transparent in the CFIUS review, but there's a lot more that could be done. We are tougher on Chinese banks, for example, but the review process is clearer for them than it is for other Chinese investment at this point.

I don't like that CFIUS does not explicitly have a mandate to deal with commercial contracts, like telecom. We have an instrument. Why leave out something that is clearly relevant? Well, you know, CFIUS should remain limited. We're politically deciding the outcome of these contracts in totally nontransparent fashion. We can do better than that.

Should CFIUS evaluate Chinese SOEs differently? Yes, in my opinion, for the reason I just gave. They are different--the combination of the anti-competitive behavior at home and their size. Does that mean CFIUS shouldn't be transparent and should say no to everything? No, absolutely not. It just means that we have to be realistic about the behavior of the firms we're studying.

One thing we should not do. I am at the Heritage Foundation after all. We should not try to compete with China on subsidies. I actually--I may have coined this phrase a few years ago at this Commission--never compete with the

PRC on subsidies; you're never going to win. We don't have the tools for that. All you're going to do is get out-subsidized and spend a lot of money and have the firm you're subsidizing on the U.S. side get swamped. So we got to find some other solution.

Overseas is simpler but not necessarily easier. SOEs only account for about 30 percent of China's exports. That's not their strength. They account for, on our tracker of Chinese outward investment, 94 percent of Chinese outward investment. That's where the SOE role is. It's not so much in trade. It's investment in third markets.

If U.S. firms want to compete with that, the obvious thing to do is to reduce the tax and regulatory burden on American firms. I'm not advocating like the only thing that we're supposed to decide tax and regulatory burdens on is competing with the Chinese in third markets. That's absurd. But if you want a response to the Chinese in third markets, you reduce the tax and regulatory burden on American firms, and political fighting over that just delays the improvement we can all agree on.

The President has said he wants to reduce the regulatory burden, and there is bipartisan agreement in some form on reducing corporate taxation. I would also hope simplifying. So let's take what we can agree on, improve American competitiveness now, and we can fight about the rest of it later.

The other thing would be multilateral and bilateral agreements. The WTO doesn't seem like it's going anywhere, which is unfortunate. Are there no other countries we can sign FTAs with? Really? None? I find this hard to believe.

If we can't sign any FTAs, how about bilateral investment treaties or other forms of investment protection? Indonesia. Brazil. There are big expanding markets out there in which we are competing with the Chinese, and they have all the state subsidies on their side, and we don't have anything on our side, including things that we could have.

A BIT with Brazil would be great if it were possible, and I don't know how much of an emphasis it is right now.

So that leaves TPP. I love TPP, but it's a potential tool, not a real tool yet. If TPP were great and successful and expanded, then, fine, that might be enough, but we're putting a lot of eggs into a basket that is going to pay off a couple of years from now, and that we can't really see what we're getting yet.

So nothing against TPP--strongly in favor--but I don't think it's sufficient as a response to Chinese competition overseas.

Now, the core of this. The core of this is it all comes back to China. Chinese firms in the U.S., Chinese firms in third markets, it all comes back to what's going on in China, and that's because I don't think financial subsidies are the key here. They're documentable, and all that, but the key is that a lot of the Chinese market is reserved for SOEs, and it's reserved for SOEs in a nontransparent and very difficult-to-challenge fashion.

So there are huge sectors you're just not allowed to compete in. And when you have that advantage, when you have automatic review and automatic scale, and you don't have to worry about competition, you haven't driven out the competition because you're better, they're just not allowed to compete with you, that is a big base on which to draw on. That's a lot of money you can transfer from your home parent to an overseas subsidiary that can potentially swamp the smaller market you're operating in.

So the number one thing the U.S. should be doing in this case is talking to the Chinese about, all right, you need to--you're going to have a state role in your economy. We're not going to get you to stop doing that. We're not trying to, but we need to know what it is precisely, information they have refused to provide for years now.

And you need to roll it back. If it's 90 percent, make it 75 percent. If it's 18 or 19 sectors, which is what I count, how about seven or eight? We're not going to successfully eliminate state prerogatives within the massive Chinese economy, but we can get a clearer picture, and we can narrow them.

Financial subsidies is "Whack-o-mole." If you try one avenue for curbing financial subsidies, they have a lot of others. The only thing that's really going to work is capital account liberalization, which is allow money to leave the country because if money can't leave, it's got to go somewhere, and they have a lot of different ways to channel it to state-owned enterprises.

I don't want to go over my time because I actually want to have a conversation. I guess, you know, the two things I say again and again and again is there have to be real priorities in U.S. economic policy towards China. You put eight, nine things on the table, you get exactly what you deserve, which is nothing.

If this is going to be a priority, and I certainly think it should be, which is why I'm here today, it has to be a real priority, not one of seven things. We're not going to add it to our list that we have now and expect to make any progress.

The other thing, on a positive side, members are always complaining that all we have with China is sticks, and they don't like it, and I understand that. TPP is positive. TPP is not we're threatening you; it's we're going to create a dynamic, hopefully, and growing trade organization with great rules, and if you want to join, you can join.

All you have to do is follow the rules, for example, on competitive neutrality with regard to state-owned enterprises. So I think TPP has a lot of potential to be that carrot or at least not a stick. We haven't realized it yet.

Other than that, the U.S. is going to have to make hard choices on what our economic priorities are; otherwise, we're just going to be listing state-owned enterprises with everything else, and we're not going to make any progress.

PREPARED STATEMENT OF DR. DEREK SCISSORS
RESEARCH FELLOW IN ASIAN ECONOMIC POLICY
THE HERITAGE FOUNDATION, WASHINGTON, DC

Testimony for the U.S.–China Economic and Security Review Commission
February 15, 2012

The Fall and Rise of Chinese State-Owned Enterprises: American Policy
by
Derek Scissors, Research Fellow in Asia Economics, The Heritage Foundation

Testimony for the U.S.–China Economic and Security Review Commission
February 15, 2012

A lot has changed in a year. In February 2011, the Commission was compiling information on the expanding role of Chinese state-owned enterprises (SOE's). Since then, the debate has noticeably swung in favor of those believing that SOE's are a global economic problem, one which requires considerable improvement in American policy.[118] How to make that improvement, unfortunately, has not been settled.

There are two components to the SOE challenge. The original and fundamental matter is the sealing off of China's huge internal market in order to protect and enhance SOE's. A new issue, less important now but perhaps equivalent in the long term, is the expansion of SOE's into the U.S. and other markets outside China.

The two are obviously related but require distinct policy responses. With regard to the Chinese market, the Communist Party's commitment to SOE's is so strong that only a decisive and extended American effort, implemented at the highest level, has a chance to lead to a significant reduction in government support. The most effective response to long-term Chinese competition outside the PRC is improving long-term American competitiveness both at home and in third markets.

The Status of SOE's

The confusion over SOE's stems from their history, in which market-oriented reform was followed by "restructuring" that renewed state prerogatives and blunted progress toward true commercial status.[119] Most SOE's are unquestionably different than they were in 1995. Their

[118] John Bussey, "U.S. Attacks China Inc.," *The Wall Street Journal*, February 3, 2012, at *http://online.wsj.com/article/SB10001424052970204662204577198833989249406.html* (February 10, 2012).
[119] This following two sections draw on Derek Scissors, "Chinese State-Owned Enterprises and U.S.-China Economic Relations," testimony before the U.S.-China Economic and Security Review Commission, March 30, 2011, at

ownership status has changed, to the point where most have mixed ownership of a sort and some can be argued not to be "state-owned" at all. They are required to behave in more commercial fashion because they operate in different markets, due to both changes at home and expansion overseas. It can be shown, though, that, a large group of very large firms can still be grouped under the SOE rubric as state-owned or controlled.

A common perception is the state began to re-advance with the financial crisis in 2008, but the process actually started with the 2002 Party Congress and political transition. The new regime, led by new Party General Secretary Hu Jintao, engineered a powerful economic stimulus starting with lending expansion by state banks (which utterly dominate banking). State banks loan overwhelmingly to state firms and, as early as September 2003, it was clear that the trend of shrinking the state had been altered.[120]

The extent of the policy change was obscured by implementation of WTO membership requirements and extremely rapid expansion of all parts of the economy. By 2006, though, it was obvious the Hu government was restoring state leadership of the economy, for strategic reasons, to control macroeconomic cycles, and to represent China overseas.

Strategic goals were addressed through regulatory protection, the most powerful subsidy SOEs receive. The core of regulatory protection is suppression of competition. There is a broad and sustained program to consolidate industries from airlines to yarn, because having too many participants is said to cause disorder.[121] When market concentration is already high, in contrast, the State Development and Reform Commission preserves it. This explains why China ranked 151st of 183 countries in World Bank's measure of the ease of starting a business.[122]

The ultimate protection from competition is by statute. The industries deemed strategic by the government, such as power, telecom, and shipping, are required to be state-dominated. There are additional sectors that are *de facto* state dominated, such as banking and the media. In both groups of sectors, SOE officers move freely back and forth into government positions.[123]

Where The State Must Rule

Autos	Information Technology	Petrochemicals
Aviation	Insurance	Power

http://www.heritage.org/research/testimony/2011/04/chinese-state-owned-enterprises-and-us-china-economic-relations (February 10, 2012).

[120] China Watch, "The Emergent Industrial Policy," Derek Scissors, September 19, 2003.

[121] "Measures to Stop Disorderly Competition," *People's Daily Online*, March 2, 2005, at http://english.peopledaily.com.cn/200503/02/eng20050302_175221.html (February 10, 2012) and Katie Cantle, "Global Competition," *Air Transport World*, November 1, 2011, at http://atwonline.com/airline-finance-data/article/global-competition-1109 (February 10, 2012).

[122] The World Bank, "Doing Business: Economy Rankings," 2011, at http://www.doingbusiness.org/rankings (February 10, 2012).

[123] Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, at http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm (February 10, 2012) and Chen Jialu, "CEO Reshuffles Signal New View of Watchdog," *China Daily*, August 24, 2010, at http://www.chinadaily.com.cn/bizchina/2010-08/24/content_11194717.htm (February 10, 2012).

Banking	Machinery	Railways
Coal	Media	Shipping
Construction	Metals	Telecom
Environmental Technology	Oil and gas	Tobacco

The situation is deteriorating, as some SOEs are now gigantic on a global scale. China has 61 of the Fortune 500, with the oil majors and State Grid in the top 10. National banks and telecoms are on some measures the world's largest.[124] State-dominated steel and coal production are approaching half the world total.[125] These firms provide massive amounts of tax revenue and employment. They are run by high-level Party cadres or their children. It was easier to build the monster than keep it chained.

Fortune 500 Ranks

Sinopec	5
CNPC	6
State Grid	7
ICBC	77
China Mobile	87
China Railways	97
China Railway Construction	105
Construction Bank	108
China Life	113
Agricultural Bank	127

Source: "Global 500," *CNN Money*, July 25, 2011, at *http://money.cnn.com/magazines/fortune/global500/2011/countries/China.html*

The State Share

The Hu government's second objective, macroeconomic control, is achieved through the ability to order SOE's to expand or contract, regardless of conditions. SOE's defy market pressures that apply to other firms, consistently over-producing and over-employing.[126] In a downturn, they do

[124] Philip Lagerkranser, "China Banks Surge to World's Largest May Be Too Good to Be True," *Bloomberg.com*, April 29, 2009, at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aueh06DOY37A* (February 10, 2012) and Janet Ong, "China Tells Telecom Companies to Merge in Overhaul (Update 1)," *Bloomberg.com*, May 25, 2008, at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYQg0d5NANkM* (February 10, 2012).

[125] Press Release, "World Crude Steel Output Increases by 6.8% in 2011," World Steel Association, January 23, 2012, at *http://www.worldsteel.org/media-centre/press-releases/2012/2011-world-crude-steel-production.html* (February 10, 2012) and World Coal Association, Coal Statistics, August 2011, at *http://www.worldcoal.org/resources/coal-statistics/* (February 10, 2012).

[126] "70% of China's Products to be Oversupply," *China Economic Net*, August 1, 2005, at http://bn2.mofcom.gov.cn/aarticle/chinanews/200508/20050800219859.html (February 10, 2012) and "70% of China's Products to be in Oversupply," *China Daily*, August 2, 2005, at http://news.e-to-china.com/show-9495.html (February 10, 2012).

not fire workers - instead receiving loans to keep paying them - and are certainly not permitted to go bankrupt. When growth is too fast, state entities are initial targets for cooling policies.[127]

The principal means of this macroeconomic control is investment. In 2001, under the previous government, urban investment stood at 2.8 trillion yuan, equivalent to 29 percent of GDP. In 2003 and 2008, SOE's responded to stimulus directives in a much more intense way than private firms. As a result, by 2011, urban investment had increased by more than a factor of 10 to 30.2 trillion yuan and was equivalent to 64 percent of GDP.[128] Investment has driven Chinese growth.

While the domestic private role is waxing, investment remains largely the province of SOE's, which generate two-thirds of the huge total. The State Statistical Bureau changed its investment survey in 2011, making numbers not quite comparable over time. Still, investment data offer the most complete breakdown by ownership. The private share has been undercounted and, with wholly foreign-owned ventures), is now at a reasonable level of 25-30 percent. The explicit state share has fallen to barely one-third.

Share of Urban Investment (type of firm)

	State-owned	Limited liability Corp.	Domestic private	Wholly foreign-owned	Partly foreign-owned	Share-holding	Other mixed ownership
2005	41.6	22.4	13.5	4.9	6.1	9.0	2.5
2008	37.1	23.5	19.2	4.8	4.7	7.9	2.8
2011	33.7	26.0	24.3	3.1	3.1	6.3	3.5

Source: China Monthly Statistics, Volume 12, 2001 – Volume 1, 2012, National Bureau of Statistics, Beijing.

This still leaves 40 percent of the story. Share-holding was the first manner of SOE reorganization.[129] It has given way over time to limited liability corporations (LLCs), in part due to the need for liability protection for overseas-listed entities.

Despite the obvious commercial designation, LLC's have always been treated separately from private firms. They are composed of subsidiaries of state enterprises such as ChemChina. These are concentrated in areas dominated by the state, the areas in which giant Chinese firms have been formed and sold stock for the purposes of domestic market protection and overseas expansion – the national champion notion.[130] The true public sector includes the state, LLC's, and shareholding entities. Hence, its investment share is approximately two-thirds (the remainder is not possible to characterize).

[127] Victor Shih, "Chinese Banks' Great Leap Backward," *The Wall Street Journal*, December 19, 2008, at http://online.wsj.com/article/SB122961611056318369.html (February 10, 2012) and "China Rules Target Big Banks: CBRC," *Bloomberg*, March 15, 2011, at http://www.taipeitimes.com/News/biz/archives/2011/03/15/2003498191 (February 10, 2012).

[128] China Monthly Statistics, Volume 12, 2001 – Volume 1, 2012, National Bureau of Statistics, Beijing.

[129] Gary H. Jefferson and Jian Su, "The Impact of Shareholding Reform on Chinese Enterprise, 1995-2001," *William Davidson Institute Working Paper No. 542*, September 22, 2003, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=429700 (February 10, 2012).

[130] Bruce J. Dickson, "Updating the China Model," *The Washington Quarterly*, 34:4, Fall 2011, at http://www.twq.com/11autumn/docs/11autumn_Dickson.pdf (February 10, 2012).

The state also leads elsewhere. Investment is financed chiefly by loans, where state firms absorb perhaps 80 percent. In bonds, the biggest "corporate" issuer has been the Ministry of Railways. Sectors which SOEs dominate accounted for nearly 85 percent of stock exchange capitalization at the end of 2011.[131]

The other key input to production is labor. At the end of the third quarter of 2011, the explicit state share of employment was 56 percent, falling from 68 percent in the third quarter of 2005. However, the remaining category is "other," which includes and obscures firms of mixed ownership that can be state controlled.[132]

As state firms are less efficient, their share of capital and labor inputs is higher than their share of outputs such as production or sales. Official data on production are not useful but a plausible estimate for the state share of production is below the employment number. Given that the comprehensive state share of labor is likely notably higher than 56 percent, the true state share of production is probably in the neighborhood of 50-55 percent.

What To Do, in China

The long-standing and still most important problem with SOE's is loss of access to the Chinese market. There is typically no market of 1.3 billion for American exports and firms operating within China, there is whatever the SOE's leave behind. If considered strategic, an entire sector can be closed. In sectors that are open in principle, the capacity of SOE's to outspend competitors keeps their share artificially high. This stems from state control of finance and other production inputs, especially land and electric power.

The market is also smaller than it should be, because consumption is effectively taxed. The repression of competition and subsidization of inputs that enable overinvestment by inefficient SOE's are financed by transferring income from households. Households pay more for inferior SOE goods and services, they pay more for land so SOE's may locate freely, and they receive lower returns on their savings so SOE's and state banks can both be subsidized. The State Council has embraced rebalancing consumption and investment since 2004 yet the opposite has occurred, because rebalancing would undermine SOE's.[133]

On the goal of macroeconomic control, it may be possible to nudge the Party to switch levers. Real interest rates have been negative for years but raising rates alone will do little if SOE's treat repayment as optional. Even market interest rates – which conceivably are a huge step forward - cannot curb SOE's if they are exempt. An indirect method of changing monetary policy, however, is through fiscal. The IMF recently advocated more use of fiscal policy and less of

[131] China Monthly Statistics, *op cit,* and "New Masters of the Universe," *The Economist*, January 21, 2012, at *http://www.economist.com/node/21542925* (February 10, 2012).
[132] China Monthly Statistics, *op cit*
[133] "China Tackles Underlying Economic Problems," *Xinhua*, August 3, 2004, at *http://www.chinadaily.com.cn/english/doc/2004-08/03/content_357329.htm (*February 10, 2012).

banks in the Keynesian management China applies.[134] The U.S. should support this change. If loans can be deemphasized, there will no longer be as much support for SOE's overinvestment and their market share may shrink.

The main event is shrinking the number of strategic sectors, as well as clarifying and perhaps capping the extent of state dominance of those sectors. Media may be a political necessity but machinery is no longer vital. Power may qualify as genuinely strategic but petrochemicals are only marginally so. Within the industries the Party refuses to relinquish, there is no sense of how big the state share must be – 51 percent, 75 percent, 90 percent? 51 percent in insurance, 75 percent in shipping, 90 percent in oil?

SOE's will naturally grab as much as they can, and are doing so. The comatose Chinese market reform effort might be revived by sustained American demands, years overdue, for both immediate transparency and the smallest possible role for SOE's across industries over time. These translate to the largest possible market shares for American goods and services and better conditions for profitable operation in those markets. Not coincidentally, they translate into the same things for Chinese private companies.

Reducing the role for SOE's will also permit actual investment-consumption rebalancing, a topic which has been discussed for years to no avail.[135] It will thus help address the trade deficit and other bilateral and global irritants. Presidential summits, the Strategic and Economic Dialogue – all tools should be employed to increase competition for SOE's.

What To Do, in the U.S. and around the World

The third goal of the Hu government's restoration of state leadership was to enable China to more successfully compete on global markets. This may seem a bit strange in retrospect but, in 2002, the trade surplus was only $30 billion and outward investment was almost non-existent. As China's trade and, now, its investment footprint has increased, responding to this new challenge from SOE's has become more pressing.

It is appealing to tie the flood of Chinese goods into the world economy since 2002 directly to the re-ascent of SOE's starting at the same time, but the link is indirect. Exports require true competitiveness and are therefore an area of relative SOE weakness.

The standard figure is that wholly and partly foreign-funded companies account for a bit over half of percent of exports.[136] Domestic private firms generated over 30 percent of exports in 2011. Since "foreign-funded" can include either a private or state majority owner, these numbers

---

[134] Shen Hong and Bob Davis, "IMF Urges Beijing to Prepare Stimulus," *The Wall Street Journal*, February 7, 2012, at *http://online.wsj.com/article/SB10001424052970204369404577206651681198934.html* (February 10, 2012).
[135] "Curtain Falls on China-US Second Economic Dialogue," *Xinhua News Agency*, May 24, 2007, at *http://us2.mofcom.gov.cn/aarticle/chinanews/200705/20070504725847.html* (February 10, 2012).
[136] "China's Private Sector Exports Surge Amid Expansion," *Xinhua*, January 11, 2012, at *http://news.xinhuanet.com/english/china/2012-01/11/c_131354868.htm* (February 10, 2012) and "Market Profile on Chinese Mainland," *Hong Kong Trade Development Council*, January 17, 2012, at *http://www.hktdc.com/info/mi/a/mpcn/en/1X06BPS5/1/Market-Profile-on-Chinese-Mainland* (February 10, 2012).

cannot be combined. However, the state share of exports is very likely to be capped below one-third and could be as low as one-fourth.

The indirect link is that SOE control of the home market forces other firms, foreign and domestic, to seek customers overseas. As China gets richer, the internal market has become more attractive but it has also become inaccessible for many firms and they continue to export as a result. The best American response to SOE's in exports is, thus, the same as in China: rolling them back in their home markets to the extent possible.

A second step is to enhance competitiveness of American goods and services. This is huge topic but there are two dimensions: home and overseas. At home, among other things, simpler and fewer regulations and simpler and lower taxes will make U.S. companies more competitive against SOE's. Overseas, bilateral, multilateral, and global trade accords will improve U.S. access. The Trans-Pacific Partnership (TPP) is a potentially wonderful initiative, but a lonely one. The U.S. should identify new countries for free trade talks, as well as seeing what can be salvaged from the WTO's Doha round.

In contrast to trade, the state drives outward investment. The Heritage Foundation's China Global Investment Tracker documents large non-bond investments from 2005-2011, including totals for specific firms that are not in Chinese data.[137] On Heritage numbers, state entities generated 94 percent of outward investment in 2011, roughly the same as in 2010. The largest investors are tightly state-controlled. This is very unlikely to change – outward investment is at the heart of the concept of national champions.

Top Outward Investors

CNPC
Sinopec
China Investment Corp.
Chinalco
CNOOC

Source: Derek Scissors, "China Global Investment Tracker Interactive Map," The Heritage Foundation, January 6, 2012, at *http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map* (February 10, 2012).

In third markets, American policy concerning SOE investment should parallel trade. Enhancing corporate competitiveness and market access - the latter through investment expansion and protection such as in the TPP or bilateral investment treaties - will maintain or extend the $3.5-trillion lead the U.S. has in global direct investment.[138]

[137] Derek Scissors, "China Global Investment Tracker Interactive Map," The Heritage Foundation, January 6, 2012, at *http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map* (February 10, 2012).

[138] While the proportion of Chinese investment is rising, the annual increment to American investment is usually larger, widening the absolute lead. U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data, December 15, 2011, at *http://www.bea.gov/international/di1usdbal.htm* (February 10, 2012).

At home, there is no short-term challenge. Chinese investment outside bonds has a trivial part in the U.S. economy, with the total since 2005 equivalent to less than half a percent of a single year of American GDP. There is a long-term issue, again stemming from the treatment of SOE's in China itself. The regulatory protection and financial and other subsidies given to SOE's could enable them to eventually distort competition in American markets. Chinese companies must be subject to all U.S. laws but special attention should be paid to anti-competitive practices, some possibly unintentional. Any major problems are some ways off but the U.S. legal system will need time to adjust to dealing with Chinese SOE's.

Conclusion: Market Over State

SOE's have become more important at home during the past eight years and are now becoming more important as international investors. The U.S. is scrambling to respond to the first event and must act soon to avoid having to scramble on the second. To improve policy, the U.S. should:

1) Make as its top bilateral economic priority the clarification and reduction of the role of SOE's, especially by trimming the large number of "strategic" sectors.

2) Support IMF efforts to deemphasize bank lending as a macroeconomic tool for China, in favor of fiscal policy.

3) Enhance the competitiveness of American companies by reducing regulatory and tax burdens.

4) Improve access to foreign markets through bilateral and multilateral trade and investment agreements.

5) Immediately begin to assess the capacity of anti-trust and other laws to address the behavior of Chinese SOE's.

There is also the matter of what the U.S. should not do. SOE's constitute a competitive challenge, in China and to a lesser extent outside. This does not mean they are superior. SOE's hurt Chinese households, waste resources and harm the environment, and strongly discourage entrepreneurship. They do not deserve imitation. The U.S. should not:

A) Subsidize exports or investment to break into the Chinese market. (Never try to compete on subsidies with the PRC.)
B) Punish American households by inhibiting competition through trade barriers.
C) Block Chinese investment in the U.S. for political reasons.

The stakes have been raised by the emergence of SOE's onto the world stage. It has become that much more important to loosen their grip on the Chinese market.

HEARING CO-CHAIR CLEVELAND: Interesting. Thank you, Dr. Scissors.
Mr. Milhaupt.

STATEMENT OF CURTIS J. MILHAUPT
PARKER PROFESSOR OF COMPARATIVE CORPORATE LAW
FUYO PROFESSOR OF JAPANESE LAW
COLUMBIA LAW SCHOOL, NEW YORK, NY

MR. MILHAUPT: Good afternoon. Thank you very much to the Commission for having me here. I'm very pleased to have this opportunity to talk about Chinese SOEs before the Commission.

Indeed, I believe that SOEs are one of the keys to understanding the Chinese political economy and the future of China's global interactions. China now has the third-largest number of global Fortune 500 companies after the United States and Japan, and the number of such companies has been increasing by 25 percent per year since 2005. Most of these are SOEs, at least broadly defined.

These firms are at the heart of state capitalism in China, but there's still a great deal to be learned about what might be called the "organizational ecology" in which these firms operate.

We tend to associate Chinese SOEs with names like Sinopec, China Mobile, and the like. But as my written testimony discusses, these national champions--the external face of China, Inc.--are actually just one facet of an extremely complex network of firms with broad linkages to the broader Chinese Party-State.

My time is limited, and I won't attempt to describe these networks in detail. They're in my written statement and also in a larger academic study which is cited in the statement.

But I do want to take my time here to emphasize the complexity and interconnectedness of the entities in the Chinese state sector.

The Global Fortune 500 firms are part of large vertically integrated business groups whose parent company is owned by SASAC, the state shareholder, and we haven't had much discussion of SASAC yet today.

These business groups, in turn, are interlinked, for example, through shareholding among key firms in the groups, through joint ventures or strategic alliances, particularly with respect to overseas projects and investments.

The national business groups are also linked to provincial business groups and even to state organs whose primary focus is not economics, such as university research institutes.

As we've heard this morning, within each level of the corporate hierarchy, a Party organ shadows the corporate organs that we're more familiar with. The Party is particularly involved in high-level personnel decisions, and the Party actually selects the CEOs of the top 50 or so SOEs, not the board of directors.

At the top of this structure is SASAC, which is itself a rather opaque entity. I believe it has both less and more power as a controlling shareholder than meets the eye. It has less power in the sense that it must share control rights with respect to key management appointments and key business decisions with the Party and with other ministries, but it has more power in the sense that it's governed by a special statute called the State-Owned Enterprise Asset Law, enacted in 2008, after a long period of interest group adjustment and bargaining.

The SOE Asset Law provides SASAC with veto power over downstream transactions within the group. So, in essence, SASAC can bypass the boards of directors of downstream entities in divestitures and mergers and the like.

In some respects, SASAC treats all of the approximately 120 central SOEs under its supervision as a single entity--as a giant diversified conglomerate. Its actions suggest that it seeks to maximize the collective profitability and power of the central SOEs rather than taking the individual corporation or corporate group as the unit to be maximized.

One example of this is the practice of rotating high level managers among firms in the same industry, which as the data in my written statement shows is quite common.

I don't necessarily mean to paint this as a sinister and dark picture. Every country has a unique form of capitalism, and the line between the state and the market is drawn somewhat differently everywhere.

Some of the features of industrial organization I've described have parallels in other countries, such as Japan, for example, with the keiretsu, or the chaebol in Korea. France has a comparatively high degree of government ownership of business, but I believe the degree and extent of intermingling between business, government, and the Party in China is unprecedented and poses a real policy conundrum for policymakers in the United States.

In terms of policy responses, I start from the premise that state-owned enterprises, Chinese and otherwise, are here to stay, that they are going to be lasting actors in the global economy and in the U.S. economy. So the first task is to fully understand how state capitalism in China actually operates, and I certainly applaud this Commission's work and the annual report in making headway against that big topic.

But I think more work needs to be done to understand how the Chinese business groups are organized and governed, and exactly what role SASAC plays in the governance of the state sector.

Above all, it's not possible to determine whether the SOEs' outward trappings of corporateness, that is governance by a board of directors responsible to an economically minded investor base, are deserving of credence from a policy perspective unless we understand who is ultimately responsible for key managerial and strategic decisions within these firms and the extent to which legal and market, as opposed to political, considerations are central to the corporate governance and incentive structures in these firms.

At a substantive level, a threshold policy question is whether we need additional across-the-board regulations or screening devices on Chinese SOEs. I tend to believe that we do not. I think the CFIUS process is fairly robust, and that enacting additional screening requirements could cause more harm than good, particularly because foreign governments are likely to respond in kind, and as we discussed this morning, I think it does bear mentioning that many entities in the United States could be characterized by an unsympathetic foreign government as SOEs.

It doesn't matter how we would characterize them. It matters how they could be characterized by a foreign government, and I'm not sure we want to go down the road of creating entirely separate body of foreign investment and trade law for SOEs.

Having said that, I do believe that U.S. legislatures and policymakers need to carefully review our national laws regulating market activity to ensure that they adequately contemplate an economy in which SOEs are major actors.

The three examples I give in my written statement are federal securities laws, the antitrust laws, and bilateral investment treaties. I think in each of these areas, it's not obvious that the law contemplates and adequately addresses SOEs as market actors.

I'll close with an example from Europe that I think illustrates the approach that will increasingly be necessary in the United States. In two recent antitrust cases involving Chinese SOEs, the European Commission said the only way to assess the market impact of the proposed transactions was to delve deeply into the connections between the particular Chinese SOEs involved in the transactions and the wider Chinese state. I think this is the best way forward--market by market, firm-by-firm analysis, with an eye toward effectuating the underlying objectives of each particular substantive area of law.

That's not going to be easy. It's going to be difficult. It will be painstaking, but I don't think that there is a better alternative.

So thank you very much, and I look forward to our discussion.

PREPARED STATEMENT OF CURTIS J. MILHAUPT
PARKER PROFESSOR OF COMPARATIVE CORPORATE LAW
FUYO PROFESSOR OF JAPANESE LAW
COLUMBIA LAW SCHOOL, NEW YORK, NY

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on Chinese State-Owned and State-Controlled Enterprises
February 15, 2012

One distinctive feature of Chinese state capitalism is the existence of approximately 120 large, state-owned enterprises (SOEs) controlled by organs of the national government in critical industries such as steel, telecom and transportation. Although only a few of these firms are household names outside China, they dominate major industries within that country and are increasingly active in global markets. As *The Economist* recently noted, "as the economy grows at double digit rates year after year, vast state-owned enterprises are climbing the world's league tables in every industry from oil to banking."[139] China now has the world's third largest concentration of Global Fortune 500 companies (sixty-one)[140], and the number of Chinese companies on the list has increased at an annual rate of 25% since 2005.

More than two-thirds of Chinese companies in the Global Fortune 500 are state-owned enterprises. Excluding banks and insurance companies, [141] controlling stakes in the largest and most important of the firms are owned ostensibly on behalf of the Chinese people by a central holding company known as the State-Owned Assets Supervision and Administration Commission (SASAC), which has been described as "the world's largest controlling shareholder."[142] Though the elite firms such as Sinopec and China Mobile (commonly referred to as "national champions") are listed on stock exchanges in Shanghai, Hong Kong or other world financial capitals, they are nested within vertically integrated groups. Their majority shareholder is the "core" company of the group – which is itself 100% owned by SASAC. The core company coordinates the group's activities and transmits business policy

[139] The Economist, March 12, 2011, p. 79.
[140] Behind the United States and Japan. Global Fortune 500 rankings are based on revenues.
[141] The banks are majority owned by other agencies of the state, and supervised by the Chinese Banking Regulatory Commission and the People's Bank of China.
[142] Boston Consulting Group, SASAC: China's Megashareholder (Dec. 1, 2007), available at http://www.bcgperspectives.com/content/articles/globalization_strategy_sasac_chinas_megashareholder/.

to group members. Individual corporate groups are often linked through equity ownership and contractual alliances to groups in the same or complementary industries, to provincial-level business groups, and even to state-controlled institutions without a direct economic role, such as universities. Top corporate managers simultaneously hold important positions in the government and the Chinese Communist Party.

While the basic outlines of this system are now widely known, in many respects the concept of state capitalism in China – particularly the organizational structure and broad governance regime surrounding the SOEs under SASAC supervision – remains a black box. Understanding the full implications of "state ownership and control" in the Chinese context requires expanding the unit of analysis beyond individual, listed companies and examining the larger organizational ecology in which the national champions operate.

In this brief written statement, I hope to shed some light on the mechanisms of state capitalism in China by exploring the architecture of its central SOEs,[143] and to raise some of the potential policy implications of my analysis.

The Architecture of Chinese SOEs

State capitalism in China has a remarkably complex architecture. Critical to understanding Chinese SOEs is an appreciation of the extensive networks in which they are enmeshed. The national champions that serve as the external face of the SOEs are typically part of a vertically integrated business group focused on a particular industry or sector, not diversified groups involved in a range of industries. Corporate groups must be registered with the central government in order to be recognized as such. One of the key benefits of group registration is eligibility to establish a finance company, described below. Shareholding within these groups is hierarchical: firms higher in the structure own downstream subsidiaries, but there is very little upstream or cross-ownership among group firms. These features of Chinese corporate groups contrast with most Japanese (so-called horizontal) *keiretsu*, which are diversified groups with extensive cross shareholding among member companies.

The individual business groups have several distinct components:

[143] A more detailed analysis of the subject can be found in Li-Wen Lin & Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623.

1. Core (Parent) Company: The top firm in the group is the core company, whose shares are wholly owned by SASAC. Core companies were typically formed by "corporatizing" a government ministry with jurisdiction over a particular industry. For example, each of the core companies in the national petroleum groups was hived off from the former oil ministry and transformed into a corporate entity with limited liability, a board of directors, and shares held by a state-affiliated shareholder. The core company acts as a holding company, serving as an intermediary between SASAC and group firms that engage in actual production. The core company coordinates information flow and resource allocation within the group. It transmits policy downward from the state to group members, and provides information and advice upward from the group to state economic strategists and planners.[144]

2. Listed company: The external face of the national champion is not a group of companies but a single firm, a minority of whose shares are publicly traded on Chinese or Hong Kong stock exchanges and often on other major exchanges as well. For example, PetroChina, one of the largest oil companies in the world, whose shares are listed on the Shanghai and New York Stock Exchanges, is the external face of the CNPC Group, whose core company is the China National Petroleum Corporation.

While the listed firms are the focus of most scholarly and media attention devoted to Chinese corporate governance, a much broader lens is required to fully understand Chinese state capitalism.

3. Finance company: As noted, one of the key benefits of registration as a corporate group is eligibility to establish a finance company – a nonbank financial institution that provides services to group members. Finance companies are exempt from the general prohibition in Chinese law on inter-company lending. Under the current legal framework, a finance company provides services on behalf of group members similar to those of commercial and investment banks. Subject to approval by banking regulators, they are authorized to engage in a wide range of activities, including accepting deposits from and making loans

[144] Internal group governance structures are specified in a legally binding agreement called Articles of Grouping, which is adopted by all members. The core company dictates the terms of the Articles, and the internal governance rules grant it veto rights with respect to the group. Many Articles of Grouping provide for plenary or management bodies to facilitate group or delegated decision making, respectively, but these organs typically either have only advisory power or are structured so that the core company effectively controls their decision making processes.

to member companies, providing payment, insurance, and foreign exchange services to members, and underwriting the securities of member firms. They also engage in consumer finance related to the products of group members, and invest in securities issued by financial institutions. Deposits from group member companies comprise their main source of funds. Almost all finance companies are members of state-owned groups, either at the national or provincial level, and many are formidable in size.

The creation of nonbank finance companies within business groups – what one commentator has called "outside the plan financial intermediaries"[145] – poses an obvious competitive threat to the largely state-owned commercial banking sector. As such, Chinese regulators have been vigilant about not expanding the scope of finance company activities to the point that they constitute a complete substitute for Chinese commercial banks, which remain an important source of funding for SOEs.

4. Research Institutes: Chinese policy makers have encouraged business groups to include research institutes as members in order to promote high technology development and increase international competitiveness. Most of the national business groups contain one or more research institutes. The research institutes conduct R&D, particularly applied research in areas related to the group's products and production processes. Often, the research institutes collaborate with universities on particular projects to derive complementarities between the applied focus of business R&D programs and the theoretical approach of academic researchers. Typically established as not-for-profit institutions, the research institutes receive funding from the core company in the group.

Larger Networks

The foregoing are the main components of the corporate groups and the mechanisms by which member firms are linked. But the individual groups are embedded in larger networks involving the Chinese state and the Party.

1. Inter-group Networks: While groups in the same industry do compete domestically, SASAC has encouraged collaboration among the national groups in overseas projects to increase their

[145] Yingyi Qian, Financial System Reform in China: Lessons from Japan's Main Bank System, in Masahiko Aoki & Hugh Patrick eds., The Japanese Main Bank System: Its Relevance to Developing and Transforming Economies 552, 569 (1994).

global competitiveness. These linkages (in the form of joint ventures or contractual alliances among SOEs in the same or complementary industries), are designed to facilitate technological development, as well as a host of other objectives, such as information sharing, marketing, and pooling of capital for capital-intensive projects.

2. National-Provincial Champion Networks*:* National groups under SASAC supervision are sometimes linked to business groups under the control of local governments. These linkages are the result of an evolving dynamic between the central and local governments. Initially, local governments sought investment from the national groups to rescue moribund local SOEs. As the national groups expanded, local governments began to view them as a competitive threat to local businesses. Local protectionism increased, and a push was made to create "provincial champions." The relationship between national and local groups appears to be in flux again as a result of the global financial crisis, which prompted renewed cooperation. The local governments now view the national champions as sources of support for small and medium-sized enterprises, which suffered when they lost the backing of foreign and private companies. For the national groups, which are under pressure from their governmental supervisors to grow, tie-ups with local groups are an avenue of expansion.

3. Business Group-Government/Party Networks: The leading business groups are tied to institutions of the central government and the Chinese Communist Party in many ways. For example, an organization called the China Group Companies Association is formally designed as an intermediary between the national business groups and the central government. Its board of directors is composed of senior government officials and top managers of the most important national business groups. The Association is a vehicle for conveying the concerns of top SOE managers to the State Council. A second bridge between the groups and the party-state is the practice, with roots dating to the period prior to the establishment of SASAC, of granting substantive management rights over a nationally important SOE to the ministry with supervisory authority over the industry in which it operates. Personnel exchanges between SASAC and the SOEs it supervises creates another link. Finally, a number of positions in elite government and party bodies such as the National Peoples Congress and the National Congress of the Communist Party are reserved for leaders of the national SOEs.

SASAC as Controlling Shareholder

Atop the national groups is SASAC, ostensibly "the world's largest controlling shareholder." But drawing definitive conclusions about SASAC's precise role and the scope of its authority in the governance of the national SOEs is difficult. The agency has both less and more power vis-à-vis the SOEs under its supervision than meets the eye.

SASAC, established under the State Council in 2003, represents an attempt to consolidate control rights over the national SOEs. In the past, the corporatization effort was complicated by dispersed control rights held by a variety of ministries with jurisdiction over separate activities such as trade and investment, as well as the Communist Party, which was involved in wage and labor issues. This legacy persists: SASAC defers to other agencies, and even to the SOEs themselves, on substantive issues outside its realm of expertise. SASAC's location in the government organizational chart may contribute to this tendency. Although SASAC is a ministerial level agency, so are fifty-three of the most important SOEs under its supervision. As one commentator notes, "In practice, SASAC has faced an uphill struggle to establish its authority over the SOEs that it supposedly controls as a representative of the state owner."[146]

In a key area of control – senior managerial appointments in the central SOEs – SASAC shares decision rights with the Communist Party in a highly institutionalized arrangement. The top positions in fifty-three central enterprises, including board chairmen, CEOs, and Party Secretaries, are appointed and evaluated by the Organization Department of the Party. This is a legacy of appointments practice prior to the establishment of SASAC. Some of these positions hold ministerial rank equivalent to provincial governors and members of the State Council; others hold vice-ministerial rank. Deputy positions in these enterprises are appointed by the Party Building Bureau of SASAC (the Party's organization department within SASAC). A separate division of SASAC, the First Bureau for the Administration of Corporate Executives, assists in this appointment process. Appointments and evaluations of top executives in the remaining central enterprises are made by yet another division of SASAC, the Second Bureau for the Administration of Corporate Executives.

[146] Mikael Martin, Whose Money? The Tug-of-War over Chinese State Enterprise Profits, FIIA Briefing Paper No. 79 (April 2011).

Note that the standard corporate mechanism for the appointment and evaluation of senior executives – the board of directors – is missing entirely from this process. Indeed, only thirty-five of the core companies of the national business groups even have boards of directors as of this writing. Although SASAC and the Party have begun taking steps to bring boards of directors into the appointments process and to create boards for those core companies which do not yet have them, the steps taken thus far leave little doubt that the Party does not intend to relinquish appointment authority with respect to the most important enterprises and the highest level appointments.

SASAC and the Party also rotate senior corporate and party leaders among business groups. (See Table 1) Most of the corporate rotations reflected in the table are of directors or vice CEOs, and the party rotations are for positions below Secretary of the Party Committee. However, from time to time top executives in key industries have been rotated. For example, in April 2011, SASAC rotated the CEOs of the three central petroleum enterprises, each of which is a Global Fortune 500 Company. Such rotations are obviously in tension with the separate corporate and competitive identities of the firms. The practice may suggest that the national SOEs are treated for some purposes as a diversified meta-group under common, if attenuated, control of SASAC. As Table 1 shows, leaders are also rotated among the spheres of business, government, and the Party.

[Insert Table 1 here]

In contrast to these institutional constraints against SASAC's sole authority over the SOEs, the agency's legal footing places it in a position of unusual strength as a shareholder. Until recently, there was no overarching legal authority governing SASAC in its role as controlling shareholder. In 2008, a Law of the Peoples Republic of China on State-Owned Assets of Enterprises (SOE Asset Law) was enacted to "safeguard[] the basic economic system of China…, giving full play to the leading role of the State-owned economy in the national economy."[147] In essence, the law formally recognizes SASAC as an *investor* – a shareholder in the national SOEs, with the ordinary rights and duties of a shareholder. Ostensibly, the law confines SASAC to this role[148] and governs the agency's performance of its

[147] SOE Asset Law, Art. 1.
[148] SOE Asset Law, Arts 11-14.

functions as an investor.[149] But there are no formal mechanisms in the law to enforce SASAC's responsibilities, and in reality, the law grants SASAC powers *greater* than those available to it as a shareholder under China's Corporate Law. Most importantly, the law essentially grants SASAC veto power over share transfers that take place downstream within the SOE corporate groups. Thus, SASAC can bypass the board of directors in consolidating or transferring control of corporations under its supervision.

Potential Policy Implications

State-owned and affiliated enterprises are an important part of the Chinese domestic economy, and are likely to be influential actors in China's political economy for the foreseeable future.[150] They are also likely to be increasingly active players in the global economy. At the current pace, China will soon surpass Japan as home to the second largest number of Global Fortune 500 companies.

There is a danger, of course, in treating all "SOEs" – even those from a single country, as monolithic actors who march to a single drummer. The reality is much more complex, and we should expect heterogeneity among Chinese and other SOEs to increase as they interact in global markets. This obviously complicates the task of policymakers in determining how to respond to investment and other market activities by SOEs. The United States has a robust regulatory framework for foreign investment provided by the CFIUS process under Exon-Forio and the Foreign Investment and National Security Act (FINSA), as well as industry specific requirements. I doubt that the benefits of additional, general screening requirements directed at Chinese and/or SOE investments in the United States would outweigh the costs, including the likelihood that other governments will reciprocate with restraints on U.S. foreign investment activity.[151]

However, as I hope the foregoing analysis indicates, the Chinese SOE sector is highly complex in its organizational structure and deeply linked to other organs of the Chinese party-state.

---

[149] See e.g., SOE Asset Law, Art. 69 provides for unspecified disciplinary measures against SASAC staff who neglect their duties as investor. Art. 70 subjects a shareholder representative appointed by SASAC to personal liability for loss caused by failure to carry out SASAC's instructions.

[150] For a similar conclusion, see the prepared statement of Dr. Derek Scissors before this Commission on March 11, 2011, available at http://www.uscc.gov/hearings/2011hearings/transcripts/11_03_30_trans/11_03_30_final_transcript.pdf.

[151] Numerous U.S. entities might plausibly be defined by foreign lawmakers as state-owned or controlled, including General Motors, Fannie and Freddie, the Alaska Permanent Fund Corporation, and any financial institution with outstanding liabilities to the government under an emergency program such as TARP.

Outward appearances of adherence to standard corporate law norms and governance principles may be somewhat misleading without a complete understanding of the larger organizational ecology in which these firms operate. In order to evaluate the adequacy of the U.S. regulatory regime, legislators, policymakers and scholars must extend the focus of analysis beyond individual (particularly listed) firms, and take account of the broader networks in which Chinese SOEs operate. They must also come to a better understanding of the role and objectives of SASAC in the governance of the national business groups.

The reality of SOEs – Chinese and otherwise – as major actors in the global economy raises a basic question for U.S. legislators and other policymakers: Do existing laws regulating market activity adequately contemplate an economy in which state-owned or controlled enterprises are major players?

In some specific areas of law, measures have been taken to address the issue. For example, the Department of Justice, with judicial support, takes the position that under the Foreign Corrupt Practices Act, a bribe to an employee of an SOE is treated as an improper payment to a foreign government official. And in FINSA, Congress resolved several possible areas of ambiguity in the CFIUS process with respect to mergers and acquisitions of U.S. corporations by government-controlled enterprises.

In other important areas, however, it may be necessary to re-examine the adequacy of the current legal regime in the face of SOE market activity. Without attempting to provide an exhaustive list, I offer three examples. First, does the federal securities law disclosure regime provide investors with a complete and accurate picture of the ownership and governance of Chinese SOEs? This question is important both where the shares of a Chinese SOE are listed on a U.S. exchange, and where a Chinese SOE acquires shares of a U.S. publicly listed company. Problems with Chinese firms listed on U.S. securities markets through the so-called reverse merger process have generated significant skepticism about the quality of auditing practices and the accuracy of public disclosures of Chinese firms accessing the U.S. capital markets. While reverse mergers have not been the listing method used by Chinese SOEs, these problems do highlight potential inadequacies in the U.S. listing and disclosure regime vis-à-vis Chinese issuers. With respect to securities investments in U.S. firms, the Williams Act disclosure regime should be re-examined to ensure that it is adequately designed to reveal all material information about a foreign state-owned or controlled shareholder, particularly where the shareholder may be investing in concert with other entities under ultimate control of the state.

Second, is the antitrust regime equipped to accurately assess the competitive effects of SOE behavior in U.S. markets? At a very basic level, it is worth noting that the Sherman Act speaks only of *private* restraints of trade. Are SOEs private actors for purposes of the antitrust laws? What is the relevant unit of analysis in considering market effects of SOE conduct – a specific firm, the business group to which it belongs, or a number of groups under common control of a state shareholder? The European Commission appears to have adopted a sensible approach to this issue. In two recent cases involving Chinese SOEs, the Commission "delved deeply into … [the] SOE's relationship with the wider Chinese state."[152] In those cases, the Commission took the position that since the SOEs are owned by the Chinese state, it is necessary to assess whether the SOE is an independent entity or whether it belongs to a larger group, including other enterprises over which the state exercises decisive influence.[153]

A third example is the proper scope of investment treaties to which the United States is a party. Bilateral investment treaties (BITs) generally provide for investor-state, but not state-to-state, dispute resolution. Where an investment is made by a state-owned or controlled enterprise, should that entity be characterized as an "investor" for purposes of the treaty, such that a dispute relating to the investment falls within the scope of the BIT's procedures? Or is the dispute more properly characterized as state-to-state, and thus outside the scope of the BIT?[154]

As these brief examples illustrate, given the increasing interactions of Chinese SOEs in the global economy, evaluating the adequacy of U.S. laws regulating market activity by state-owned or controlled enterprises requires a deeply contextualized understanding of the organizational structure of Chinese business groups and their relationship to the wider Chinese state.

---

[152] Herbert Smith Competition, Regulation and Trade e-bulletin, October 3, 2011, available at http://www.herbertsmith.com/NR/rdonlyres/62CCAAB3-61E6-4CCB-A116-8D7C8122110F/0/ChineseStateownedEnterprisesundertheMicroscope28September2011.html)%20%20NDRC.

[153] China National Bluestar/Elkem (Case COMP/M.6082), notified to the Commission on Feb. 24, 2011; DSM/Sinochem/JV (Case COMP/M.6113) notified to the Commission on April 8, 2011.

[154] For analysis of this issue, see Mark Feldman, The Standing of State-Owned Entities under Investment Treaties, in Karl Sauvant ed., Yearbook on International Investment Law and Policy 2010-2011, at p. 615.

Table 1 Leader Rotations in the Chinese Central Enterprises

Year	Leader Rotations:				
	Between Central Enterprises	From Central Enterprises to Government/Party	From Government/Party to Central Enterprises	From Local SOEs to Central SOEs	Total Rotations
2004	27	6	13	0	46
2005	27	5	14	0	46
2006	20	3	10	1	34
2007	33	7	16	0	56
2008	NA	NA	NA	NA	50
2009	NA	NA	NA	NA	27

*Leaders including members of board of directors, CEOs, vice CEOs, chief accountants, secretaries of Party Committee, deputy secretaries of Party Committee, and secretaries of the Party's Discipline Inspection Committee.

** Data Source: China's State-owned Assets Supervision and Administration Yearbooks 2005, 2006, 2007, 2008, 2009, 2010.

Panel III – Questions and Answers

HEARING CO-CHAIR CLEVELAND: Terrific. Thank you.

Commissioner Wortzel.

COMMISSIONER WORTZEL: Thank you all for your very helpful written submissions and your oral testimony.

Ms. Drake, you discussed in your testimony a CFIUS-like process that might be used as a test of SOEs and whether they're operating under market rules. I wonder if you or any of the other panelists could outline some of the criteria that would be used in this CFIUS-like body that you suggest?

And what agencies or departments of the federal government would oversee and manage that process?

And then this is kind of related, but particularly, Derek, you tell us what the United States should not do. You said the United States should not exclude SOES, Chinese SOEs, for political purposes. I accept that. But if you accept the CFIUS process and having national security concerns as valid, where could they be expanded?

In other words, would the entire enterprise of the United States Army be considered a national security asset? Would our electrical power grid be a national security asset? Or our nuclear plants?

So any of you can comment, but Ms. Drake to start.

MS. DRAKE: Thank you so much, Commissioner.

In terms of a CFIUS-like process or the CFIUS process itself if its mandate were expanded, I think there are a number of criteria they could look at in providing more fulsome assessment of SOE investment in the United States. Of course, they already apply a heightened level of scrutiny to SOE investments, but only looking to the national security implications.

There are models in Canada and elsewhere that also look at economic implications. The Canadian model looks at employment impacts, the trade impacts, but it also looks at how the proposed investment would impact sourcing of raw materials in Canada, would impact Canadian technology and innovation policies, and so it's a much broader perspective.

They also look at how it will impact Canadian cultural policies, which I don't think would necessarily be anything we would include in our process, but it certainly is much more broad than national security.

And also when they look at SOE investments, in particular, they look at the governance structure of the SOE, and they look at the commercial or lack of commercial operations of that SOE to determine how that would impact each of the economic factors that it looks at, and transparency is one of the keys here.

Creating a process like this at a minimum would give us more information about SOE investments that are occurring in the United States, and where necessary would give us the ability to ask those investors to submit to certain undertakings or certain monitoring arrangements or other things to ensure that they actually are investing on a commercial basis, particularly with regard to access to critical raw materials and critical technologies in the U.S.

Right now when CFIUS looks at this, it looks at what's critical from a national security perspective, which is often also economically critical, but there are other aspects of that analysis that could look at the economic impacts.

In terms of what agencies could oversee this process, I think that could be a matter of debate. It could be within CFIUS. It could be a separate process. It's certainly something that you would want to have a lot of interagency input into to ensure that it's taking into account all of the different domestic interests here in the United States.

And I just want to underline I absolutely agree with my fellow panelists that foreign investment can bring enormous benefits in terms of employment, in terms of economic growth, and I'm not at all proposing that we ban SOE investment or anything of the kind, simply that we make sure it actually is serving the interests of the United States broadly written.

DR. SCISSORS: Okay. You know sectors, this is one of those things "you know it when you see it," but I'll try to give an outline here. Let's assume that there's going to be a serious confrontation in the future between the U.S. and China. SOEs will respond to the directives from their government. They may not like it, they may actively oppose it in the lobbying period, but they will respond. We have lots and lots of examples of this, fortunately not in a big confrontation with the U.S. and China.

So if SOEs have ten percent of the U.S. steel market, I don't really care. If SOEs are tied into the U.S. telecom network, I do care. So things where the whole functioning of a sector can be affected by the participants, any of the participants, to me are sensitive. Things where, okay, you lose some production, that's not that interesting. Oh, my goodness, SOEs are not going to provide textiles to American malls. Don't care.

So that's the--you know, I could go through line by line, but some of the sectors are, you know, they require some analysis, and maybe that's something the Commission would like--not by me--the Commission would like to ask other people to do, which is go through sector by sector and talk about which sectors are relevant, but basically it has to do with, and you have an integrated network of a kind, the whole sector is threatened. When you have separate production outlooks, it's just those production outlets, and it's not nearly as dangerous.

I do want to say one thing about the other question. An econ test--the Canadians and Australians I think they're just making a mistake. The test is not the investment at the time. The Chinese can always set up an investment that's going to have economic benefits at the time, and so when we play around with that, it's just economic extortion. I don't want us to do that.

The test is after they're operating in the U.S., are they starting to operate, are they violating antitrust laws, are they engaging in anti-competitive behavior? It's not an investment test; it's an operating test after the investment. That's where I would worry about SOEs.

The original deal can be structured in a way that's going to pass the test, and it becomes pretty much what the Chinese are going to do. They try to extract as much out of you as possible to get into the market. I don't want us to do that. I do want us to watch ongoing Chinese behavior to see if it's harming competition in the United States.

MR. MILHAUPT: I would just add one thing, which is FINSA amended the CFIUS process I think in a very important way, to trigger an automatic investigation where an acquisition is made by, quote, "government-controlled entity."

So I agree completely with Ms. Drake, that we want a process that is going to force disclosure of governance structure, ultimate decision-maker, commercial objective, et cetera. I don't know enough about how the CFIUS process plays out in practice, but I don't see how you could determine whether an acquisition is government controlled or not without delving deeply into those sorts of questions.

So if that isn't happening currently, it seems to me that it should be simply to be in compliance with what FINSA is contemplating.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Fiedler.

COMMISSIONER FIEDLER: Dr. Scissors, you track SOE investment in the United States. Is there any single place in the United States government that does?

DR. SCISSORS: Not that I'm aware of because I get lots of questions from people in the U.S. government, which suggests that they don't have their own information source.

COMMISSIONER FIEDLER: So we don't know. Forgetting the fact that they're covering investment through the BVI or the Cayman Islands, we don't know what they own?

DR. SCISSORS: We have some--I don't mean to imply there is no government data. There is government data, but we don't have the breakdowns--you know, the states do their own breakdowns. They do them at different years. Commerce is just starting to update its direct investment statistics, which were terrible. So we don't have a unified coherent government database. I don't mean to imply we have no idea. We have some idea.

COMMISSIONER FIEDLER: Well, no, we have some idea, but we don't know what the real universe is. So we don't know if a BVI company has purchased something unless they've told us that they're Chinese--ultimate ownership is the state enterprise in China.

DR. SCISSORS: We treat the Caymans and BVIs as if they're independent investors.

COMMISSIONER FIEDLER: Getting to, Ms. Drake, all of your point, that there's insufficient information to implement policy, much less insufficient information to necessarily make policy, what's the problem with registration of foreign companies operating in the United States? You have to tell us who you are and who your ultimate owners are. I'm miffed that we don't do it. Most other major countries do that.

DR. SCISSORS: Well, I mean I'll give you a non-legal answer. We do ask them to register. It's just that we allow answers that are insufficiently specific.

COMMISSIONER FIEDLER: Yeah, we register them at state level.

DR. SCISSORS: Right, but we also allow them to say, you know, every entity in the U.S. that's operating has to be registered at the level of "I am this entity," not who my parent company is and I am in an offshore tax haven or whatever. That's my area of registration. That's permissible. The reason we don't--so we do that already. The reason it's hard is that it requires a lot of corporate disclosure and a lot of investigation to backtrack to the ultimate parent company and the ultimate zone of registration. It's a lot of resources and a lot of intrusiveness.

COMMISSIONER FIEDLER: Unless they are, for some reason, forced to disclose it upon penalty of something, as in we find out later, you're forced to divest; right? And maybe I would disclose up-front who I am if I had a downside on the other end that was something I didn't want to contemplate.

MR. MILHAUPT: The process works better with public firms obviously.

COMMISSIONER FIEDLER: Yeah.

MR. MILHAUPT: With private firms we are in somewhat something of a netherworld, but the anonymity of the corporate form exists for everyone.

COMMISSIONER FIEDLER: I understand that, and the previous panel I conjectured as to the reason that it continues--okay--despite the danger posed to the United States is the convenience of U.S. firms. It's a political question.

So unless we're willing to take on that question, we are never going to have the information base to know what our problems are.

MS. DRAKE: Well, you could do it in a nondiscriminatory manner if you required information from any--

COMMISSIONER FIEDLER: I'm fine with getting that from everybody.

MS. DRAKE: --firm that is state invested, state controlled, and there would be very few U.S. firms that would be affected by such a rule.

COMMISSIONER FIEDLER: Right.

MS. DRAKE: But it would get at the targeted concern then.

COMMISSIONER FIEDLER: Which is just state controlled.

MS. DRAKE: Right. Exactly.

COMMISSIONER FIEDLER: Right. The CFIUS process, if I'm not mistaken, in its first instance is voluntary; is it not?

HEARING CO-CHAIR WESSEL: Voluntary with sanctions.

COMMISSIONER FIEDLER: With sanctions. But are we talking about a voluntary?

MS. DRAKE: It could be done either way, but voluntary with sanctions if the sanctions are strong enough could be pretty much the same as mandatory. So it's more of a technical distinction than a fundamental one, I think.

COMMISSIONER FIEDLER: We seem to be discounting the fact that we don't want to ban state enterprises from operating in the United States, and I know that many other countries have state enterprises, and then that raises the question of sovereign wealth funds. Okay.

But they do pose a unique problem; do they not?

DR. SCISSORS: They, to me, yes. Chinese state enterprises pose a unique problem because there are more of them at a scale. So, yes, we have sovereign wealth funds, which are a form of state ownership certainly, but we don't have sovereign wealth funds operating across a whole range of sectors and being, as my colleague pointed out, you know, Fortune 500 entities across a whole range of sectors.

I will say that, you know, I would much prefer, and I don't mean to interrupt your question, to judge on the basis of behavior rather than identity. So I'd rather sanction a behavior of a company than their identity.

COMMISSIONER FIEDLER: Well, Derek, I mean on the other hand, on an ideological basis, the Heritage Foundation hasn't sort of endorsed state ownership lately; has it?

DR. SCISSORS: No. I would love if Chinese SOEs were all broken up into small private companies, but--

COMMISSIONER FIEDLER: Well, I mean and perhaps we should have policies that don't encourage their growth. I mean if we all identify it as a problem of some dimension, some unknown dimension, why in God's name do we want to encourage the further development of it by allowing them to make profit, albeit even if they create 2,000 jobs in Ohio for that state?

I mean there's got to be some recognition of a threshold of where we want the world to go and we want to participate in it. I mean I'm not a raving capitalist, but, on the other hand, I am not, I am not a--

HEARING CO-CHAIR WESSEL: That's an understatement.

COMMISSIONER FIEDLER: No. I don't believe in state ownership. Okay. Generally speaking. Certainly not on the scale that you see in Russia or the United States. So why are we accepting of this? I come back to the notion that they're carrying a bag full of dollars and a whole bunch of our profit-making people--okay, capitalists--don't care where the dollars come from as long as they can scarf up some of them despite the potential national security problems or economic security problems in the long run.

So I don't know, I'm not going to so willingly accept the notion that they should be allowed to do business in the United States, and nobody has given me, other than they're carrying a bag full of money, a lot of reason for that.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

CHAIRMAN SHEA: Thank you all.

Dr. Scissors, I recall, and correct me if my memory is completely wrong, that you testified last year on the issue of state-owned enterprises, either last year or 2009, and you were on a panel with Dan Rosen. And what intrigued me about your testimony coming from the Heritage Foundation was that you suggested that, a notion of reciprocity, that we'll allow Chinese state-owned companies to invest in the United States if they opened up their domestic sectors to U.S. companies, and you suggested that this was a leverage point for the United States, and Dan Rosen said, no, either you're for FDI or you're not, and that ended the story.

So I was intrigued that you raised that notion as a potentially valuable leverage tool against the Chinese, and I didn't see any of that in your testimony that you submitted to the Commission this time around. So I was just wondering have you had a change of mind about that or where do you stand on it now?

DR. SCISSORS: I haven't had a change of mind, and what I, hopefully, I said clearly last time--I've had many occasions to fight with Dan about this--is reciprocity is not a dirty word. It's in the WTO. It's in the WTO for a good reason. Does that mean everything should be determined by strict reciprocity? No. Because the U.S. and China have different structured economies. The whole idea that the sectors are the same in each side wouldn't make any sense in the first place.

But the fact that China doesn't allow proper access to its market is one of the things the United States should consider in deciding Chinese access to our market.

CHAIRMAN SHEA: Okay.

DR. SCISSORS: I have not backed off on that. The solutions, you know, I just wanted to write something different than last year.

CHAIRMAN SHEA: Would you make it one of your top--you don't like to have eight ideas on the table. You think we should narrow it to maybe two or three. Would you make that one of the two or three?

DR. SCISSORS: Yes. To me, and I just want to get 30 seconds on this, to me, subsidies to SOEs are the single-biggest Chinese distortion of the relationship.

CHAIRMAN SHEA: Okay.

DR. SCISSORS: And it ties back into the investment-consumption imbalance in the Chinese economy, which ties to the trade deficit, both directly and indirectly. So, yes, that would be number one on my list because it's connected to so much other stuff and one of the tools we would use. It's not strict reciprocity, but the idea that reciprocity as a principle is globally accepted and valuable.

CHAIRMAN SHEA: Okay. Great. Thank you.

I have a couple questions for the lawyers, but I'm not finished with you, Dr. Scissors. When you say we should--

DR. SCISSORS: Doctor and the lawyers, you know.

[Laughter.]

CHAIRMAN SHEA: --we should not block Chinese investment in the U.S. for political reasons. Now "political" is a very big malleable word. I mean so if a Chinese SOE happens to be selling enormous quantities of refined petroleum to Iran or an enemy or what the United States considers a threat to its own national security, that wouldn't necessarily, investment by that company into the U.S. might not necessarily trigger a CFIUS process, but it might trigger other statutory issues.

But is that something you think should not be a consideration?

DR. SCISSORS: No. I would make a distinction there between policy and politics. Policy there, we have an established policy not to import crude and refine it from Iran. A company that's violating that policy is liable to U.S. sanction.

What I would say about politics is we don't actually have any policies preventing a Chinese investment in a steel mill in Louisiana or Mississippi. We just don't like it. All right. Now, that is politics, and that I want to disallow.

CHAIRMAN SHEA: Well, okay, well, then that's the third question I have. You talk a lot about--you mention households, consumer, we should not inhibit competition through trade barriers so you're talking about consumers. What about U.S. jobs? Would you concede that a Chinese SOE who invests in the United States might have an unfair competitive advantage in the U.S. domestic market that could impact the jobs of Americans in a negative sense?

DR. SCISSORS: That's why I prefer a process that emphasizes their behavior here after the investment rather than the investment itself. The initial investment is going to create jobs in the U.S., and their operation in the U.S. may create jobs in the U.S.

If they engage in anti-competitive behavior, which they do at home, that can cause monopolization on the production side and reduce jobs in the U.S.

CHAIRMAN SHEA: So you think there are existing--

DR. SCISSORS: That's what I want to talk about.

CHAIRMAN SHEA: --in place that would protect--

DR. SCISSORS: I am not a lawyer. I don't know that those existing laws are sufficient. I would yield to my colleagues. I'm worried, without conclusion, that they might not be sufficient.

CHAIRMAN SHEA: Okay. Well, I have 28 seconds. I want to get one question into Mr. Milhaupt.

You mentioned SASAC. My understanding is that the Chinese state-owned companies initially didn't pay a dividend to SASAC, but recently they were required to be paying dividends to SASAC, and people speculated that this might help with domestic consumption in China. If they're giving out dividends to SASAC, that money can be used for security net or welfare programs for the domestic population in China. Is there any--

MR. MILHAUPT: I don't think that that's how those dividends are being used. I think they're being used to cross-subsidize SOEs that are also under SASAC control. I mean I don't have definitive information about this, but I think there's a lot of cross-subsidization that goes on among the SOEs under SASAC control, and so I think, first of all, I don't think they're getting--they certainly are not getting all the dividends from these firms.

I think this has been a source of a lot of political struggle among SASAC and various other ministries. But my impression is that they're using these funds to take care of acquisitions, divestitures, and the like, to try to boost the profitability of the SOEs and eliminate some of the unprofitable ones.

CHAIRMAN SHEA: Okay. Thank you.

CHAIRMAN SHEA: Chairman Wessel.

HEARING CO-CHAIR WESSEL: Thank you all for being here.

Dr. Scissors, just a quick comment first because you said that it's neither carrots or sticks. I'm an advocate of a sharp carrot because I think that can work periodically so I urge you to look at that.

You mentioned your ongoing debates with Dan Rosen, and I remember or I was told, I guess, about one you did at the Wilson School last year. I'm wondering if you could just give me some more information? You were talking, as I understood it, about the calculus that the Chinese government uses regarding outward-bound investment in assessing the intent of the outward-bound proponent in terms of jobs.

What have you heard from your interlocutors, et cetera, in China when you've had that discussion?

DR. SCISSORS: I think what you're referring to is a remark I've made several times, and correct me if I'm wrong, that if you try to propose an outward investment, the first question is why are you creating jobs overseas instead of jobs in China?

HEARING CO-CHAIR WESSEL: Right.

DR. SCISSORS: And so mineral--financial investments that are stock holdings is not really a job question. Acquiring minerals that will feed the industrial machine in China, that's job creating in China, those are all fine. But when you try to move into some other area, you get this question of, okay, why are you not just doing that here?

And, you know, American corporations get a little, comparatively light political pressure to bring money home and create jobs here. China gets a "you can't do that unless we're satisfied with the answer to this question."

HEARING CO-CHAIR WESSEL: Okay. That was something I was just trying to clarify that.

Ms. Drake, let me ask you a question. We've had a lot of discussion today about the impact of subsidized capital in the U.S., and we had discussion of Anshan Steel, et cetera.

Correct me if I'm wrong, and Mr. Milhaupt, you, as well. My understanding is if a Chinese SOE creates a greenfield investment here, and understanding, as you said, Dr. Scissors, we shouldn't just look at day one, we should look at long term. Long-term, two years from now, if they had built their furnace, as Tianjin Pipe did, as I understand it, and built it $500 million, no cost of capital, and they begin to--their pricing structure is thereby lower than a U.S. company, and jobs are lost or production is lost, there's no existing remedy in U.S. law for what I would consider the anti-competitive impact of that.

Is that right? Am I?

MS. DRAKE: That's my understanding. Part of it is the lack of a screening mechanism, and, unlike Dr. Scissors, I actually think that a screening mechanism can be complementary to efforts to continue to monitor behavior further down the road in terms of collecting information, getting companies to agree to undertaking to continue to provide that information, et cetera.

But as I mentioned in my testimony, there's a gap in U.S. law when it comes to predatory pricing, that if that steel mill, if it could show that it would never hope to recoup the losses from that predatory pricing behavior, that would not be considered anti-competitive behavior under current U.S. jurisprudence.

Now, this is based on a defensible theory, if you have market actors or commercial actors, on the idea that either a firm would never engage in such behavior in the first place if it could never recoup its losses, or it would eventually go out of business, and over the long term, there would be no enduring harm to consumers or to competitors.

But when it's a state-owned enterprise that's involved, they can go on for many years without recouping their losses, driving competitors out of business, and fulfilling state policy goals with state support at the same time. So I do think there is a significant gap in U.S. law and policy in this area, and it's something that should be closed.

HEARING CO-CHAIR WESSEL: Please, Mr. Milhaupt.

MR. MILHAUPT: I would just add to it, I think that's exactly right, and this is what I was suggesting in my statement, that some of our legal theories and doctrines that don't contemplate this type of actor, this type of animal, maybe need to be rethought.

I happen to think that the better way to do that is by law, and to focus on behavior once here rather than an ex ante screening mechanism, but the point is that we may have some gaps in our legal system, given this new type of animal, and that we need to rethink this.

HEARING CO-CHAIR WESSEL: I understand.

Ms. Drake, you and your firm have been notable litigants, or plaintiffs, I guess, in many cases. In a previous panel, we were talking about the SEC and the disclosure there. When you look at a case and you try and put together injury or any other type of information, how valuable do you find SOE disclosures if they're listed on a U.S. market or on another market where you can get access?

Do you find those comparable to Western firms? Do you have the transparency and the information you might need to be able to litigate a case effectively?

MS. DRAKE: Unfortunately, the information that we would want to see is not there on a consistent basis so I would say that every once in awhile we find the needle in the haystack, like the China Unicom disclosure that its procurement practices might not be in the interests of its investors and pose a risk to its investors because it's based on a state policy of preferring domestic suppliers over foreign suppliers.

HEARING CO-CHAIR WESSEL: Right.

MS. DRAKE: You don't see any other SOEs disclosing that, but I would be shocked if they were not involved in similar arrangements.

So more fulsome disclosure requirements, more consistent disclosure requirements would make a huge difference, but I would add these should be applied not only to SOEs themselves, but also to U.S. companies and any other companies listed in the U.S. that have business dealings with SOEs.

The American Superconductor example came from their SEC filing.

HEARING CO-CHAIR WESSEL: Right.

MS. DRAKE: But you see because it's a small company, it was material enough that they actually included the language of the contract in their filing. You don't see a GE, a GM, a huge company like that, considering a single joint venture agreement or supply agreement to be material enough to include in its SEC filings.

We could actually get a lot of information about SOE practices by also requiring our own companies to disclose more material information about the terms they've been forced to agree to in order to do business with the state-owned enterprises in China or in other countries.

HEARING CO-CHAIR WESSEL: Great. Thank you.

MR. MILHAUPT: May I add one point on that on the securities disclosures? What I found is that the securities disclosures of the Chinese SOEs listed in the United States tend to be very bland and generic with respect to management and with respect to upstream shareholders.

So occasionally you will find in the bio of a CEO, you will find a reference to a simultaneous Party position, for example, but absolutely no context for understanding that, and even that is rare. You don't always disclose the Party affiliations. There's almost never, or perhaps never, a reference to SASAC as the ultimate controlling shareholder. They will say 51 percent of our shares are held by CNPC, our parent company, full stop. But what they don't say is that the parent company is owned 100 percent by SASAC. There is no discussions of the implications for that.

So, to me, there's a question of is that materially misleading disclosure? I mean I wouldn't draw a conclusion about that, but there was a discussion this morning about whether the risk profile is presented in a materially accurate way, and I have questions about whether the governance structure of the SOEs is presented in a materially accurate way.

HEARING CO-CHAIR WESSEL: So--and I apologize for the time--but with a CD&A or any of the others, do you find the disclosure adequate?

MR. MILHAUPT: Well, they're bland and generic, as all U.S. disclosures are. And I guess, you know, lawyers are responsible for that in part, but I think it is a question of whether an investor has accurate information to understand who's ultimately making the decisions, and I'm not sure that that's the case with respect to these entities.

HEARING CO-CHAIR WESSEL: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes. I am a flaming capitalist or whatever it was called.

COMMISSIONER FIEDLER: Raging.

COMMISSIONER WORTZEL: Raving.

COMMISSIONER BLUMENTHAL: Raging. Raving. Lunatic capitalist.

COMMISSIONER WORTZEL: You're a flaming something or other.

COMMISSIONER BLUMENTHAL: Yes.

HEARING CO-CHAIR WESSEL: Okay. At least you're not vicious like Larry. That's okay.

[Laughter.]

COMMISSIONER BLUMENTHAL: Right.

So I have a question, I guess for Dr. Scissors--two questions. Others can answer as well.

The first is when we talk about investment, let's say the steel question that's come up because Commissioner Slane is talking specifically about an investment in Ohio, I want to get an apples-to-apples comparison. We're not comparing, it seems to me, a U.S. steel company that's about to make this investment versus the Chinese steel company. We're comparing a Chinese steel company versus nobody making this investment. Is that correct?

DR. SCISSORS: It depends on the situation, but that's often the case. That's certainly the case when governors are very solicitous of the investment. It's they are down to their last choice; they didn't start with China.

COMMISSIONER BLUMENTHAL: And is that the case in your understanding with Chesapeake and Devon? We're not talking about somebody else investing versus--we're talking about China investing or nobody investing?

DR. SCISSORS: No, that isn't actually my understanding of the Chesapeake. I mean Chesapeake has other partners. What we're talking about is more investment than you would have gotten otherwise, and not only more investment, but it's not a one-for-one replacement.

It's not $600 million more. It's, boy, we have $600 million gap, and the Chinese will give us 900 million. So there can be projects where people are interested. It's just that the Chinese are more interested, and a lot more interested.

COMMISSIONER BLUMENTHAL: Okay. But I just wanted to get, when we talk here about anti-competitive practices and losing jobs and so forth, in the case of this steel company, again, it would, I think we're talking about no investment in Ohio versus--

DR. SCISSORS: Right.

COMMISSIONER BLUMENTHAL: Yeah.

DR. SCISSORS: When you're a foreign investment, it's hard for foreign investment not to create jobs initially because, you know, there's capital being used, and this capital is being used for a reason. So most of these cases, you're either adding jobs or you're putting jobs in where there were going to be none, and in both cases, there's initial job creation.

COMMISSIONER BLUMENTHAL: Also, this question--you intrigued me with something you said about what we can and cannot focus on, and one of it had to do with capital account liberalization. What I wasn't able to follow--

DR. SCISSORS: Sorry.

COMMISSIONER BLUMENTHAL: --was how that applies to dealing with subsidies and SOEs, and if you could take me through that logic, as well as explain how we can, what we can do to open up the capital account.

DR. SCISSORS: Well, sorry, about rushing through the end there. There are a lot of different channels for the Chinese to use financial subsidies, and one of the mistakes the U.S. government makes and has been for a long time is we focus, hey, we've solved this problem, and they have five other things they can do to do the same thing.

You have to try, if it's possible, and sometimes it's very hard to cut to the core, and what I try to do by saying capital account liberalization is if money is allowed to leave China--there's an article today about foreign money never being allowed to leave China. You can, you know, Hotel California--you check in with your investment, and you can never get your profits out.

Chinese money, ordinary households, much bigger problem. If money is allowed to leave China, the banks are forced to be a little bit more disciplined. They're still going to obey government orders when push comes to shove because they have to. But they're forced to be at least somewhat more disciplined because their deposit base is at risk. Right now they can do anything, and the money can't go anywhere. So that's the mechanism.

And then how to achieve capital account liberalization. I mean it's--I'm sorry Commissioner Wessel left--it's the sharp carrot, I guess. You know, at one point you have to say, look, you--

COMMISSIONER BLUMENTHAL: Or the orange stick.

DR. SCISSORS: Right. You promised us a schedule for capital account liberalization years ago. You committed to it as a goal. It's an internationally--you know, the IMF is involved; the WTO is involved. Are you lying? I mean just push the subject rhetorically: did you lie? Because we'd really like to see it.

And then the carrot being the U.S. can offer rather considerable technical assistance because guess where a lot of the money is going to go when it leaves China? Right? So is that, I don't have a magic wand, but it is something they've committed to. It's very embarrassing for them that they're too cowardly to do it, and we can offer them some reassurance in a way that would be stabilizing for the international financial system.

COMMISSIONER BLUMENTHAL: Thank you.

HEARING CO-CHAIR CLEVELAND: I've just nominated you to be the new USTR.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Carolyn.

COMMISSIONER BARTHOLOMEW: Thanks. And thank you to all of our witnesses. It's very interesting testimony.

I have actually a couple of observations that go, Dr. Scissors, to some of what you've said, and to my colleague, Mr. Blumenthal.

I think one of the issues about the impact of the investment--I know, Dan, you were talking about a specific plant that perhaps nobody else was investing in. But the concern is the impact, and Ms. Drake, you mentioned that, you know, that once they've gotten the subsidies and they've gotten it, they can produce and undercut other American manufacturers working in that same sector.

So it's not enough to say, well, they're investing, nobody else is investing in that plant, and so therefore it's okay without considering the bigger picture of what's going to happen in that industry and in that sector. That's one point.

Derek, you talked about the operating test after, and Mr. Milhaupt, you also mentioned you don't much like ex ante--yeah. My concern there really is that the damage is done, but by the time that happens, if what you do is you don't do anything until you see how the behavior has happened, the damage is done, and, while, yes, it would be wonderful if our laws, we determined then and changed our laws in order to accommodate this, I think we've all seen that our legislative process doesn't work that quickly and doesn't work that smoothly.

So I understand the theoretical example of that, but I'm really concerned about the real world impact of what happens if you sort of say, okay, look, everything is going to be okay, but we're going to watch it once it's happened.

DR. SCISSORS: Well, let me just say something quickly because it's very fast. Chinese investment as a share in the U.S. as a share of U.S. GDP is so small that, I mean, you know--

COMMISSIONER BARTHOLOMEW: At this point.

DR. SCISSORS: Right. And so we have time. I agree with you that if this were a pressing issue right now, we weren't going to be able to snap our fingers and change U.S. law, but we're not in that situation. It's not a pressing issue right now, and one of the things I think the value of this hearing is to raise legislative awareness of, as my colleagues know better than I, there are issues that we should look at, and we need to do this. It's going to be a bigger issue going forward. Let's use these years we have well.

MR. MILHAUPT: I would just add that I think on the point that Chinese direct investment is rather low, the Chinese business people I talk to suggest that the CFIUS process has had an effect in deterring direct investment here. They are afraid of becoming the next CNOOC and the political fallout and the bad publicity that comes with that.

So the screening process is having an effect. We don't see firms being rejected, but that doesn't mean it isn't deterring Chinese investment. I'm not sure that's a good or bad thing. I'm not an economist, though I think my sensibilities lie close to those of Dr. Scissors, but the theory of our legal system is you don't prejudge someone by their identity, you look at their conduct, and I don't see any basis for treating SOEs differently than that based on what's happened so far.

So I agree completely, we have time. I think we can be thinking about wherethe gaps are in our legal system that don't adequately contemplate this kind of actor and address that rather than putting up a blanket screen to deter conduct that hasn't occurred yet.

COMMISSIONER BARTHOLOMEW: Ms. Drake, anything you want to add?

MS. DRAKE: I would just reiterate, as I said before, that I believe a screening process is just that: it's a screen; it's not a wall. And it can actually help in monitoring later behavior if that screening process is used to impose certain transparency obligations, reporting obligations, other undertakings.

Under the Canadian process, when they look at SOEs, some of the SOE investments, some of the undertakings they ask them to agree to are, for example, complying with SEC type disclosure rules, even if it's not a publicly-listed company. That's something that would help in monitoring the company's behavior further down the road to see if problems arise.

So I don't see the screen as the end all, be all, and I actually think it could assist in addressing or giving us the tools to address anti-competitive or injurious behavior in the future.

COMMISSIONER BARTHOLOMEW: Then there's a question of recourse. Congressman Visclosky was here earlier. The Magnequench issue came up: you know, the Chinese company had made some promises about what it was going to do; it didn't abide by its promises. What recourse is there if that's what happens?

MS. DRAKE: Well, that is a difficult question because, especially in that example, what they did that was not consistent with its promise is that it left. They left. So you can't exactly force them to come back. You can try to impose some sort of financial penalties or other penalties, try to seize whatever assets might be there.

But if the way they're not complying is by leaving, that makes life quite difficult. But if they are still invested in the U.S., strengthening the antitrust regime is one thing that can be done. Strengthening the domestic trade remedy laws. We have provisions that are meant to deter investors from seeking to circumvent antidumping and countervailing duty orders by just engaging in assembly in the U.S. from imported inputs.

But those rules have certain thresholds, certain requirements, that may actually be too high and not take into account how easy it would be for SOEs to circumvent those sort of trade remedies by engaging in some sort of state-backed investment in the assembly.

So there's a lot of different pieces that we need to look at to make sure that we are actually putting teeth into the process and are able to incentivize the right kind of behavior.

COMMISSIONER BARTHOLOMEW: Thank you. Is there a second round?

HEARING CO-CHAIR CLEVELAND: Yes, there will be.

Mr. Milhaupt, you in your prepared testimony talked about the

Sinochem case in the EU, or you reference it, and I think in your spoken testimony, you talk about proceeding on a market-by-market and firm-by-firm basis as we review investments and transactions.

As I understand from your prepared statement, the Sinochem case went forward after this more thorough review that considered the ecology--I like that word--the business ecology.

Can you talk a little bit about what happened in that case that you think made it an effective review process? Was there something that the EU did that was different that we might learn from--there are no guarantees in life--but that improve the potential outcome?

MR. MILHAUPT: Well, I think what they did was very simple and very commonsensical, which is to say let's not just look at the specific entity that's engaging in the transaction. Let's broaden the lens and look at the whole host of factors behind this entity.

Let's look as best we can based on whatever data we have, and they looked very deeply into Sinochem's own disclosures, which I think is a way of suggesting the importance of those disclosures, that they be fulsome. But they looked at those disclosures and decided, you know, this entity is part of a much larger enterprise, and so we need to consider the market impact of that larger enterprise.

Now, having gone through that, they decided that the market impact was still--

HEARING CO-CHAIR CLEVELAND: Minimal.

MR. MILHAUPT: Was still minimal, but I think it's that approach. That's what I mean by firm-by-firm and market-by-market. I don't think there is anything magical about that. It seems entirely commonsensical to me, but I think that is what is going to be required as Chinese and other SOEs begin interacting more fully in the U.S. market.

HEARING CO-CHAIR CLEVELAND: In that context, do you think--again, we debated the year before last improving the disclosure requirements on SEC filing documents, and we've had a fulsome debate amongst the Commissioners as to whether or not the fact that you are a Communist Party member, or in the senior leadership, and the CEO represents a material risk.

How would you go about addressing issues? Sorry. The question is whether or not it should be identified as material information when the corporation--

MR. MILHAUPT: Right.

HEARING CO-CHAIR CLEVELAND: --has to reflect that which might present a risk to shareholders—investors? Sorry.

MR. MILHAUPT: Sure. Materiality under the securities laws is--a reasonable shareholder would like to know it. Information that a reasonable shareholder would like to know is material.

HEARING CO-CHAIR CLEVELAND: Yes.

MR. MILHAUPT: And so it seems to me in thinking about the decision-making structures, the governance structures, if the board of directors of the firm is bypassed by some entity that stands above the corporation and setting the compensation or is making key managerial decisions, as a shareholder I sure would like to know that.

And so if we just use the definition of materiality in our own securities laws, again, I'm not drawing conclusions--

HEARING CO-CHAIR CLEVELAND: Right.

MR. MILHAUPT: --but I do think this is a very important question to be asking, is all material information being disclosed here? The Party affiliation, per se, I'm not sure is necessarily so important. I mean lots of people join the Party in China for reasons that have to do with networking and professional advancement and so on.

But if someone is serving in a very high level Party post and simultaneously in a senior government position, then I think some context about that role would be very helpful. What is the context? What are you doing in those positions rather than simply a line in the bio that says, you know, chairman of the Party committee within the company or whatever it may be, which you do sometimes find? But I would like to see greater context for these positions.

HEARING CO-CHAIR CLEVELAND: If you could give some thought to what might flesh out this material information clause that would be as a reasonable investor, you would, or as an investor, you would reasonably like to know and come back to the Commission, we'd appreciate that.

I think it would help, and if any of you have that kind of perspective, it would be helpful to us because we've struggled with that very question of being a Communist Party member. Well, lots of people are. So where is the threshold and what should the standards be?

Commissioner Shea.

CHAIRMAN SHEA: I just have a technical question for Mr. Milhaupt, and then I'll just ask Dr. Scissors another question.

FINSA. FINSA amended CFIUS, and as I understand it, if the entity making the acquisition is a government-owned entity or a government entity, it triggers--there's an automatic presumption that it needs to be reviewed, but it's an investment in critical infrastructure; right? Or am I wrong there?

Is it just any investment, or investments in critical infrastructure?

MR. MILHAUPT: Well, the CFIUS process is still the underlying framework so we're screening for national security or critical infrastructure, but if it is a government-controlled entity, then it triggers an automatic--

CHAIRMAN SHEA: Right. But the whole thing is framed by critical, national security and/or critical infrastructure?

MR. MILHAUPT: Yes.

CHAIRMAN SHEA: Okay. Professor Scissors, or Dr. Scissors, you, again, I'm going back to we should not block Chinese investment in the U.S. for political reasons.

I just want to flip that. From your experience, have you seen Chinese SOE investment globally for political reasons?

DR. SCISSORS: All right. Now, political is hard. Yes, but it's not I mean the definition of political that I would use, and I'll explain it so that you can decide. Most of it is not.

And what do I mean by that? Because the dominant way that Chinese SOEs invest outward is to acquire resources, and they like to acquire technology that doesn't usually work. But resources, and that's not--it's not a political directive. It doesn't benefit their CEO or his mentor in the Party, but it is obviously tied to politics because that resource acquisition enables Chinese industrial production, which employs lots of people, which is the main lever the Party has over the economy.

So it's several steps removed from politics, without a doubt, but there's a reason why the Chinese overwhelmingly invest in resources. There's a reason why the go-out program looks the way it does. There's a reason why the biggest national champions are resource firms, and it's not market forces. It's that was the base direction from the government.

CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Mr. Milhaupt, a quick question for you going back to FINSA and the CFIUS changes.

My recollection is that the CFIUS standard is also a "controlling transaction," which is a term of art. I mean the SEC, I believe, it's--what--five percent? In another situation, it may be 50 percent or something in between. That's not changed by the question of whether they're an SOE or not; is it?

MR. MILHAUPT: That's right. CFIUS does not define control.

HEARING CO-CHAIR WESSEL: Right.

MR. MILHAUPT: And so what FINSA adds is automatic review if it is a government-controlled entity, and I think actually FINSA--remember, FINSA was passed at the time that there was a lot of controversy over sovereign wealth funds.

HEARING CO-CHAIR WESSEL: Uh-huh.

MR. MILHAUPT: And I think FINSA was, at least in part, directed at the sovereign wealth fund.

HEARING CO-CHAIR WESSEL: But it doesn't change the control test, meaning that despite being an SOE, if you take 12 percent of a company over, and the CFIUS doesn't view that as control, it would not be an automatic review; would it?

MR. MILHAUPT: That's my understanding as well.

HEARING CO-CHAIR WESSEL: That it would be a review?

MR. MILHAUPT: Would not be.

HEARING CO-CHAIR WESSEL: No, that it would not be.

MR. MILHAUPT: Would not be.

HEARING CO-CHAIR WESSEL: That was my question.

Ms. Drake, a quick question for you, I believe. Tianjin Pipe, billion dollar facility in Texas. If they wanted--and they're not importing anything from China, everything they're doing is in the domestic market--if they wanted to block a trade case against China in a similar sector, and they had enough market power, they could. They have standing under the trade laws; is that right?

MS. DRAKE: They would have standing under the trade laws as a domestic producer. There are tests that allow the exclusion of companies from the domestic support calculation if they are--

HEARING CO-CHAIR WESSEL: An importer.

MS. DRAKE: --an importer.

HEARING CO-CHAIR WESSEL: Right.

MS. DRAKE: Or related to an importer. But it's mainly used to exclude direct importers, and so if they are not importing, they would be considered part of the domestic industry. If they posed a new trade case on political grounds or what have you, the inquiry would not delve that deeply. It would just say you're a domestic producer; you're not importing. Your opposition to this petition counts and could, if it's large enough, spell the end of that petition and inability of other domestic companies to get trade relief.

HEARING CO-CHAIR WESSEL: So just walk me through this because you said a related party. The fact that they are an SOE and related by governmental control would not negate their ability to block? That's never been tested; has it?

MS. DRAKE: That's never been tested, and normally the focus is on those that are importing directly. The relationship issue is not one that has been explored and certainly not in the context of SOEs, and going back how we might define relations at a political level, it's more, you know, it's my affiliate--

HEARING CO-CHAIR WESSEL: Right, right.

MS. DRAKE: --my direct subsidiary, et cetera.

HEARING CO-CHAIR WESSEL: Same control group or something?

MS. DRAKE: Right. Exactly.

HEARING CO-CHAIR WESSEL: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thanks very much.

Mr. Milhaupt, I'm a little confused, something to do with SASAC, and I just wondered if you could flesh it out a little bit. You note that a commentator says that in practice SASAC has faced an uphill struggle to establish its authority over the SOEs. And then on the next page, you talk about that SASAC essentially has veto power over share transfers. In other words, it can bypass the board of directors to consolidate or transfer control of the corporation.

I'm having trouble reconciling those. That's a pretty powerful thing. It's powerful power to be able to transfer control of the corporation. How do I reconcile that with they're not very powerful or they're struggling to establish their power?

MR. MILHAUPT: I'm not sure I can reconcile it either. SASAC is an enigma. And if you talk to Chinese, they don't fully understand what SASAC is. In my research for the underlying academic paper, I heard a great variety of views on SASAC's power. Some Chinese dismiss it as an empty box for Party control. I don't agree with that, but some Chinese think it's an empty box.

Other people say that it is literally a checking-the-box exercise. It's just a few bureaucrats sort of making sure that there are boards of directors and so on in these firms, a kind of compliance committee.

So the Chinese themselves don't agree on this. I think the point here is that just as the SOE sector itself is not monolithic, there's great heterogeneity among these firms. I think SASAC is a conflicted entity that's a work in progress, and it's still working out its own limits of its own authority.

So, on the one hand, it defers to the Party, with respect to key management appointments. On the other hand, it defers to substantive ministries with respect to key business decisions, but it does have, as a shareholder, it seems to have this superpower, this one element of a superpower with respect to downstream share transfers.

So, yes, I agree with you, that's a very, very powerful tool, but it isn't everything, and when you have Party overlords and you're also contending with other ministries, this all has to be worked out somehow. I have no idea how it's worked out, and I certainly hope to try to do research to find out, but this is a black box.

COMMISSIONER BARTHOLOMEW: Are there any examples of it having exercised that authority? I mean would we even be able to find out if they had?

MR. MILHAUPT: There are some cases, in fact, because this, of course, conflicts with Chinese corporate law, and Chinese corporate law scholars are very unhappy with this particular law because they see it as eroding the legitimacy or undermining the legitimacy of the corporate law.

There have been cases in which a transaction was challenged, and my understanding--I have not done deep research into this--but my understanding is that the Chinese courts have come to conflicting conclusions about whether the SASAC law should trump the corporate law or the reverse. I think they tend to side with SASAC, perhaps not surprisingly, but I think even the courts are not speaking with one voice in this area. So you're confused about it, and so am I.

COMMISSIONER BARTHOLOMEW: Okay. All right. Thanks.

Derek, did you have something?

DR. SCISSORS: Yeah. I mean, the legal jurisdiction here is way over my head, but what my colleagues said about heterogeneity is right on. There are a set of Chinese companies who don't answer to SASAC. They don't answer to their ministries either. They answer to people on the Politburo that are directly in line that that's their sector. These are really big companies. They employ hundreds of thousands of people. They're huge tax contributors.

They're just in another world, and SASAC doesn't apply to them. This is pro forma. They go through the motions afterwards if they're supposed to. So Shenhua Coal, which is China's biggest coal producer, is vital to the Chinese economy.

But there are other regional coal producers who want to maybe integrate across provinces, and now you've got a battle and what terms in the province. One province wants this, and the other province wants that, and now there is some sort of mediation that has to go on, and there SASAC is one of the players, and they are granted a certain status because they're supposed to be one of the players as opposed to the people who are just meddling for political reasons.

So I thinkwe have examples of consolidation in the steel industry where SASAC played a role. It would not play a role if Baosteel wanted something and the Party Secretary in Shanghai wanted it, too. That would be the end of that.

But when there is a conflict, as there was in several of the big steel mergers, then SASAC does play a role, and that's how you reconcile these two views. They're commenting about difference instances.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Fiedler.

COMMISSIONER FIEDLER: I want to follow up a little bit on Commissioner Cleveland's discussion about our hearing where we looked into SOE disclosures and combine it a little bit here. Nobody wants to--everybody seems to react against country-specific action. Okay. But we sort of finally got the head of corporate--International Corporate Finance to say, yeah, China has some unique characteristics that other countries don't have.

So, for instance, John Thornton was on the board of a Chinese company, was interviewed by McKinsey, and I think it was one of the telecoms, and he talked about executives and board members who are Party members had a separate meeting from the board of directors. So I sort of looked at all of the SEC disclosure. I thought that was--I mean that sort of met my materiality test, and I thought it should meet anyone's, and there was no such disclosure of that.

Now, a state enterprise in Sweden doesn't have the same dynamics. Okay. And all we were sort of probing was--and people have testified today, and maybe including yourselves, or including yourselves--it's a different scale here. We're talking a large scale.

So why don't we have some accommodation to country-specific circumstances when we try to govern the interaction that we have with these companies in the United States?

DR. SCISSORS: I have two answers, very quickly. One, there's a big problem with the WTO, and I'll let my colleagues get into the details, but my answer would be more along the lines of--

COMMISSIONER FIEDLER: Wait. WTO doesn't deal with investment questions, though; right?

DR. SCISSORS: Nonetheless, these bleed very quickly into trade. As you can imagine, Tianjin Pipe is the exception of the sealed-off investment company.

But my answer would be more along the lines of--and there are WTO principles obviously--my answer would be more along the line of we're not trying to discriminate against Chinese investment. This is something the Chinese do all the time. You're discriminating against Chinese investment. No. We're worried about SOE investment.

Not all Chinese investment is SOE investment. We want to separate the country from the actor. Chinese private investment is great, you know, exactly along the lines of what you're talking about before. What world do we want to encourage? We want to encourage a world of Chinese private investment.

So we don't want to discriminate against China. We want to discriminate against SOEs in the cases that they need extra screening, and the Chinese case is interesting because they have bigger SOEs, and they have a Party as well as a state apparatus, but it's not Chinese investment we're worried about; right?

COMMISSIONER FIEDLER: Yeah, yeah.

DR. SCISSORS: But picking out the country is the wrong thing to pick out. It's the state operations that we're picking out.

COMMISSIONER FIEDLER: Well, it happens to be China. It happens to be China and not Sweden. So it quickly devolves into country although I would say to you that Russia may pose similar problems. Okay. And there's a different dynamic of doing business there that if they want to come to the capital markets, there might be even different disclosure, and you don't need new laws to govern this.

You need an active SEC that makes the distinction between countries and doesn't accept boilerplate disclosure that has become the norm for not only U.S. companies, but more importantly and deceptively Chinese companies.

MS. DRAKE: I would just like to say I'm not sure that there would be a WTO problem with including rules like that, but I think what's essential is making sure that, as the Commissioner said, that it's not boilerplate disclosure, and that it is more detailed and specific about what is material and what is not, regardless of where the company might be registered or where its ultimate control may be. It may be that it only has 12 percent SOE control or SASAC control, but, nonetheless, for different reasons is not operating on commercial terms.

And in addition to understanding the board, who's on the board, how the board meets, different governance criteria, we should be also looking at related-party transactions defined broadly, to include any state-owned commercial bank, any other state-owned enterprise, and also looking at the company's risk of liability under countervailing duty laws or under other trade agreements that are posed by support it's getting from the state or other discriminatory arrangements that it may be participating in.

So there is certainly a broad array of areas where more disclosure is needed, and while it could be by country or not by country, I think the need is urgent.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Wortzel.

COMMISSIONER WORTZEL: As you were describing in problems of materiality and disclosure in state-owned enterprises, it struck me--and I know this is a state-owned enterprise hearing--but given what we know about the way Communist Party and related government organs function, we haven't even considered what it might mean if private--what really may be private enterprises in China--begin to invest, but they're controlled by princelings or the families of very senior officers in the People's Liberation Army or the Communist Party.

And I know that's another set of questions, but this might be a good way to close it out with some final thoughts.

DR. SCISSORS: That to me just argues much more strongly against identifying China as the problem because there are a whole bunch of countries from a large Middle Eastern oil exporter, companies that I don't really know that I consider them private or separate from the state or the ruling family or whatever, so once you talk about it that way, I think there is a national security issue worthy to be discussed, but it is not a China-specific issue. It is an issue that may be addressed by disclosure, but not a country-based disclosure.

COMMISSIONER FIEDLER: We just happen to be the China Commission though.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Mr. Milhaupt, I have one more question. Looking at your table in your written statement about leader rotations and the Chinese central enterprises of which 46 to 50 each year between 2004 and 2008, and then 27 in 2009. What should we take away from that chart?

MR. MILHAUPT: Well, I think it's an illustration of what was talked about, I think, mainly in the second session, about what's unique about the Chinese case. It's the scale; it's the degree of interconnectedness. That's what I take away from it.

I think there is a blend between market and government in every system, but what's different to me about China extraordinaire is the degree of intermingling. And someone made the comment that this is a new system. I think it's a new system. And I think I tend to agree with that.

I'm not sure we've ever seen a system in which business and government is so closely intertwined on such a large scale, and so I think the table is illustrative of that.

HEARING CO-CHAIR CLEVELAND: Okay. Any other questions from my colleagues?

Thank you very much for appearing. We appreciate it and learned a great deal. We look forward to hearing from you, and, as I said, please, if there are specific details on the whole question of materiality that you all could suggest in addition to the ones you just did, Ms. Drake, please submit them for the record.

Thank you very much. We're adjourned until March 26.

[Whereupon, at 3:13 p.m., the hearing was adjourned.]